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Ju 11.7/2: 1986-21

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T. C. Memo. 1986-21

UNITED STATES TAX COURT

GEORGE M. & JOAN E. HAMILTON, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 11258-83. Filed January 16, 1986.

Held: Petitioner-husband was an itinerant electrician whose tax home traveled with him. Hence, travel expenses are not deductible. Held further, petitioners failed to prove that moneys paid to petitioner-husband's former wife constituted deductible alimony.

George M. Hamilton, pro se.

Christine Colley, for the respondent.

ORIGINAL

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MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined a deficiency in the 1979 income tax liability of petitioners in the amount of $3,442. After concessions, the issues in dispute are the deductibility of travel expenses in the amount of $9,279 and the sum of $1,200 claimed by petitioners to be alimony payable to George M. Hamilton's (Hamilton's) former wife. For convenience, our findings of fact and opinion are combined.

Some of the facts have been stipulated and they are so found. At the time of the filing of the petition in this case, petitioners George M. & Joan E. Hamilton were living in a trailer park in Port Gibson, Mississippi. Petitioners apparently contend, however, that their legal residence at all times is and has remained in Cocoa, Florida. During all of 1979, petitioners were husband and wife. Hamilton was a member of the International Brotherhood of Electrical Workers, Local 756, the headquarters of which was in Daytona Beach, Florida in that year. The expense deduction involved food, lodging, car expense, employer travel allowance reimbursement, and depreciation on a travel trailer.

Hamilton was divorced from his first wife by order of the Circuit Court of the 18th Judicial Circuit, Brevard County, Florida in Civil Action No. 74-2880-CA-01-F by decree dated October 11, 1974. That decree incorporated and approved a property settlement and child custody agreement executed on October 7, 1974 between Hamilton and his former wife, but that agreement is not before the Court. The divorce decree directs that the sum of $100 per month be paid by Hamilton to his former wife plus costs for a period commencing on November 1, 1974 and terminating on October 1, 1975, for "rehabilitative alimony." Apparently, the property settlement required the payment of the sum of $7,000 in periodic installments. The payments, claimed by petitioners as deductible alimony in the year 1979, represent 12 monthly installments of $100 each on the $7,000 property settlement.[1]

The burden of proof on this issue, as well as on the travel expenses, is upon petitioners. Rule 142.[2] The evidence before the Court appears to indicate that the $1,200 claimed as "alimony" by petitioners in 1979 was in reality paid on a property settlement and hence would be nondeductible. There are no facts in this record to indicate how the former Mrs. Hamilton treated the receipt of this sum of $1,200 in the year 1979 and we cannot on this record definitively determine whether or not this payment would constitute "alimony or separate maintenance" for purposes of section 71(b)(1) and section 215, but the indication in the decree of divorce is to the contrary. In any event, petitioners, who have the burden of proof on this issue (Rule 142), have failed to show error in respondent's disallowance of this deduction. We find for respondent on this issue.

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[1] The amortization schedule applying to the $7,000 payments, which is in evidence, shows that out of the $1,200 paid in 1979, $407.17 was applied to interest. Petitioners 1979 income tax return reflects an interest deduction in the amount of $407 under the heading "home mortgage." During the trial, however, Hamilton testified that interest on the home mortgage was $396.21, and we note that petitioners' 1979 Schedule A shows an interest deduction of $396. Hence, petitioners apparently claimed a double deduction to the extent of $407, which amount is deductible as interest but not as alimony.

[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

Hamilton contends that he has been a resident of Cocoa, Florida since the year 1954. In 1964, Hamilton purchased a three bedroom, two bath house in Cocoa, Florida, which during 1979 and apparently prior and subsequent thereto was occupied by his son and his son's wife. His son paid the utilities, although the utilities were still in Hamilton's name, but did not pay any rent on the house. Petitioners paid property taxes on the house. Petitioners in 1979 and thereafter had Florida license tags on their motor vehicle and both petitioners had and have Florida drivers licenses.

During 1979, and for years prior thereto and thereafter, there were many more members of Hamilton's local union than there was work available for electricians in that part of Florida. The members of the local were assigned to work in that local's area in Florida on the basis of their position on the work list. Available work was assigned to those members of the local at the top of the list. Whenever a work assignment was completed that member's name was placed at the bottom of the list. Remaining members of that local were forced to seek work elsewhere. Hamilton worked in Florida from October 1977 until April 1978 at which time he was laid off and his name went back to the bottom of the work list. From 1977 through 1981, petitioner's work locations and the duration of his jobs are indicated by the following table:

11/14/77 - 4/13/78	Cape Canaveral, Florida
4/27/78 - 5/26/78	Midland, Michigan
6/22/78 - 10/31/78	Craig, Colorado
10/78 - 5/79	California
5/28/79 - 10/25/79	Everett, Washington
11/10/79 - 12/7/79	Sulphur, Louisiana
1/10/80 - 2/29/80	San Antonio, Texas
3/80 - 5/80	Las Vegas, Nevada
7/8/80 - 9/26/80	Missoula, Montana
10/16/80 - 11/4/80	Kennedy Space Center, Florida
11/17/80 - 5/19/81	Westlake, Louisiana

Thus, from April 1978 when Hamilton was laid off from Cape Canaveral to October 1980 when he started to work at the Kennedy Space Center, Hamilton worked exclusively outside of Florida. He and Mrs. Hamilton lived in the travel trailer, depreciation on which is included as an element of travel expense. The record is silent as to whether, during the short period of time in 1977-1978 and again in 1980, petitioners occupied Hamilton's house in Cocoa, Florida. We assume, therefore, that they did not during these periods of time occupy the house but instead continued to live in Hamilton's travel trailer in which they lived during the period when Hamilton was working outside the State of Florida. During this period, Hamilton kept in touch with his union's business agent by telephone.

Hamilton's contention is that he maintained a home in the State of Florida and maintained another home "on the road" i.e., his house trailer. However, the only expense incurred by Hamilton with respect to his Florida house was for property taxes and the mortgage payments. Hamilton contends that his work at each place was temporary and, thus, that he is entitled to deduct his out-of-town travel expenses. Respondent, on the other hand, argues that Hamilton was an itinerant worker with neither a regular place of business nor a regular place of abode.

Personal expenses are ordinarily not deductible. Section 262. Section 162(a)(2), however, allows the taxpayer to deduct certain traveling expenses paid or incurred while away from home in the pursuit of a trade or business if he can establish the traveling expenses were: (1) reasonable and necessary; (2) incurred while "away from home"; and (3) incurred in pursuit of a trade or business. Commissioner v. Flowers, 326 U.S. 465, 470 (1946); Foote v. Commissioner, 67 T.C. 1, 3 (1976).

This Court has held that a taxpayer's "home" for the purposes of section 162(a)(2) is the vicinity of his principal place of business whenever his personal residence is not located in the same vicinity. Mitchell v. Commissioner, 74 T.C. 578, 581 (1980); Kroll v. Commissioner, 49 T.C. 557 (1968). There is, however, an exception to this rule when a taxpayer with a well-established tax home accepts temporary employment as opposed to indefinite employment elsewhere. In this context, temporary employment means the sort of employment in which termination within a short period of time could be logically expected and foreseen. Groover v. Commissioner, 714 F.2d 1103 (11th Cir. 1983), affg. a Memorandum Opinion of this Court; Albert v. Commissioner, 13 T.C. 129, 131 (1949). See also McCallister v.

Commissioner, 70 T.C. 505, 509 (1978). On the other hand, whenever termination of employment cannot be expected or foreseen within a fixed or reasonably short period of time, the taxpayer's tax home shifts to such place of employment so that he cannot satisfy the "away from home" requirement, Verner v. Commissioner, 39 T.C. 749 (1963).

While this record is not sufficiently complete to be able to determine factually whether or not some or all of the jobs Hamilton had during the year 1979 were temporary, it is entirely possible that some or all of them were, but in this context that is beside the point.

> The obvious precondition to a taxpayer being "away from home" is that he have a home in the first instance. In the context of section 162(a)(2) the taxpayer must incur substantial continuing living expenses at a permanent place of residence. James v. United States, 308 F.2d 204 (9th Cir. 1962). Such requirement is in accord with the purpose underlying section 162(a)(2), that being to mitigate the burden falling upon the taxpayer who, due to his business, must maintain two places of abode and thereby incur additional and duplicate living expenses. * * * [Fn. ref. omitted.] [Bochner v. Commissioner, 67 T.C. 824, 828 (1977).]

Whether or not Cocoa, Florida has ever been the tax home of Hamilton, we do not know. We do find that on the basis of this record it was not his tax home at any time between the fall of 1977 and the end of 1981. As we said in Bochner, by reason of the lack of employment opportunities in the vicinity of Cocoa, Florida and in the regional area covered by Hamilton's own local, his retention of his house in Cocoa did not make that his tax home. His tax home was, in fact, his trailer which traveled with him and the fact that he paid property taxes and mortgage payments on his house in Cocoa does not constitute the kind of dual living expenses which the "away from home concept" is designed to cover. Bochner v. Commissioner, 67 T.C. at 829. See also Deamer v. Commissioner, T.C. Memo. 1984-63, affd. 752 F.2d 337 (8th Cir. 1985), and Spinks v. Commissioner, T.C. Memo. 1985-588. We hold for respondent on this issue.

Decision will be entered
under Rule 155.

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Ju 11.7/2: 1986-22

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T. C. Memo. 1986-22

UNITED STATES TAX COURT

EDWARD J. WATT AND WILDA M. WATT, DECEASED, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 15457-84. Filed January 16, 1986.

Edward J. Watt, pro se.

Michael Kevin Phalin, for the respondent.

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MEMORANDUM OPINION

AARONS, Special Trial Judge: This case was assigned to Special Trial Judge Aarons pursuant to section 7456(d)(3) of the Internal Revenue Code and Rules 180, 181 and 182 of this Court's Rules of Practice and Procedure.[1]

In a notice of deficiency dated March 5, 1984, respondent determined a deficiency in petitioners' Federal income tax for 1976 in the amount of $3,323, together with additions to tax under section 6653(a) in the amount of $166.15, under section 6651(a)(1) in the amount of $173.75, and under section 6651(a)(2) in the amount of $173.75. Respondent also seeks an award of damages under section 6673.

Because Wilda M. Watt was deceased at the time of the issuance of the Notice of Deficiency, "petitioner" as used herein in the singular, will refer to Edward J. Watt.

At the time of the filing of the petition, petitioner resided in Torrance, California. During 1976, petitioner earned wages from the Garrett Corporation in the amount of $3,816.61 and from Hughes Aircraft in the amount of $16,272. These amounts were reflected in the W-2 forms, copies of which were filed with petitioners' joint State of California income tax return for 1976. Petitioner filed a purported Federal income tax return for 1976, but that document contained no information as to his income or deductions. Rather, each relevant space contained only an asterisk which referred to a footnote stating: "These answers are given under the protection of the 4th and 5th Amendments to the U.S. Constitution."

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended and as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

The petition herein asserts the defense of the statute of limitations.

At trial, petitioner admitted receiving the asserted wages, and admitted that wages constitute gross income. He admitted further that his employment giving rise to the wages was not an illegal activity. But he asserted that if he had reported his wages he would have subjected his entire return to possible criminal investigation due to the omission of some undisclosed income from another undefined activity. Petitioner testified that he has not been aware of any pending or threatened criminal investigation since he filed his 1976 purported return.

In a Request for Admissions, filed herein, respondent makes reference to docket No. 8110-76 involving the same petitioner and holding for respondent on issues quite similar to those involved herein. Petitioner's response to this request was that it "fails to mention that docket No. 8110-76 was appealed to the 9th Circuit Court (C.A. 79-7202)". Docket No. 8110-76 is the case of Watt v. Commissioner, T.C. Memo. 1978-495. That case was affirmed on February 23, 1981, in an unpublished opinion of the 9th Circuit. 642 F.2d 457 (9th Cir. 1981).

Petitioner has shown no basis whatsoever for his claim of protection under the "unreasonable searches and seizures" clause of the Fourth Amendment. See Edwards v. Commissioner, 680 F.2d 1268, 1270 (9th Cir. 1982), affg. per curiam an unreported decision of this Court. With regard to petitioner's Fifth Amendment allegations, the privilege against self-incrimination does not apply where the possibility of criminal prosecution is remote or unlikely. Rogers v. United States, 340 U.S. 367, 374 (1951). The privilege applies only where there is a real and appreciable danger of self-incrimination and reasonable cause to apprehend such danger. Edwards v. Commissioner, supra. Petitioner has certainly not demonstrated any such real or appreciable danger. He has admitted that during the years between the filing of his 1976 "return" and the time of trial no criminal prosecution has been threatened. The Fifth Amendment privilege may not be used merely as a method of avoiding payment of taxes owed, which would appear to be petitioner's intended objective. See United States v. Carlson, 617 F.2d 518, 522-523 (9th Cir. 1980).

Petitioner relies upon Garner v. United States, 424 U.S. 648 (1976), for support of his Fifth Amendment position. In Garner the Supreme Court stated that had the taxpayer invoked the privilege against compulsory self-incrimination on his tax return (which he had a right to do), in lieu of supplying the information used against him, the Internal Revenue Service could have proceeded against him only by seeking criminal prosecution for willful failure to file or by completing the taxpayer's return administratively. He could not have been prosecuted for any item omitted from his return based upon a valid Fifth Amendment claim. But, Garner does not apply to the instant facts. In Garner the taxpayer reported on his return that he was a professional gambler, and it was this information which was used against his Fifth Amendment objections, as part of the basis for his criminal prosecution. In the instant case, there would hardly have been a likelihood of a criminal prosecution from petitioner's disclosure of his wages from Garrett and Hughes. To extend the language of Garner to cover the instant facts would furnish a convenient means of tax avoidance or at least tax delay to anyone engaged in ordinary legitimate employment. Clearly no such result was intended by the Court in Garner.

With respect to petitioner's claim that the deficiencies and additions to tax herein are barred by the statute of limitations, section 6501(a)(1) provides, in general, that taxes must be assessed within three years after a return is filed. Where no return is filed, however, the tax may be assessed at any time. Sec. 6501(c)(3). The statute of limitations is an affirmative defense and the burden of proving that the period has expired is on the party seeking to avail himself of its benefit. Knollwood Memorial Gardens v. Commissioner, 46 T.C. 764, 792 (1966); Gatto v. Commissioner, 20 T.C. 830, 832-833 (1953). We have concluded that the document filed by petitioners for 1976 does not constitute a return. Edwards v. Commissioner, supra; Reiff v. Commissioner, 77 T.C. 1169, 1177 (1981). As petitioners failed to file a return for the taxable year at issue, we hold that assessment and collection of the deficiency and additions to tax determined herein are not barred by the statute of limitations.

The additions to tax under sections 6651(a)(1) and 6653(a) are presumed correct and are generally upheld unless the taxpayer presents evidence controverting their applicability. Abramo v. Commissioner, 78 T.C. 154, 162-164 (1982); Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972). No such evidence was presented herein. We sustain the additions under sections 6651(a)(1) and 6653(a).

As to the addition to tax under section 6651(a)(2) for late payment, we note that this addition is determined by the amount of tax actually shown as tax on the return by the taxpayer. Cf. Estate of Young v. Commissioner, 81 T.C. 879, 882 (1983). Here, no return was filed by petitioners. Accordingly, we find for petitioners as to the section 6651(a)(2) addition.

With respect to the award of damages under section 6673, the Court is convinced that petitioner's position herein is a continuation of his tax-protestor pattern, the beginning of which was manifested in Watt v. Commissioner, T.C. Memo. 1978-495. The Court warned all such taxpayers at the Calendar Call of the likelihood of a damages award under section 6673. We find, on the basis of the entire record, that petitioner instituted and maintained the present proceedings for delay and that his position is frivolous and groundless. Accordingly, damages will be awarded to the United States in the amount of $2,500.

An appropriate order and
decision will be entered.

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Ju 11.7/2: 1986-23

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T. C. Memo. 1986-23

ORIGINAL

UNITED STATES TAX COURT

BAIL BONDS BY MARVIN NELSON, INC., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 7083-73, 10026-75. Filed January 21, 1986.

Ondrej M. Kojnok and Doris Brin Walker, for the petitioner.

William E. Bonano, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

Drennen, Judge: These consolidated cases were assigned for trial or other disposition to Special Trial Judge Fred R. Tansill pursuant to section 7456(c)[1] and General Order No. 6 of this Court, 69 T.C. XV (1978). See also Rule 180 and Rule 181.

The Court agrees with and adopts the opinion of the Special Trial Judge, which is set forth below.

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[1] All section references are to the Internal Revenue Code of 1954, as in effect during the tax years in issue, unless otherwise noted. All rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise noted.

TANSILL, Special Trial Judge: Respondent determined deficiencies in petitioner's taxable years (fiscal years ending each June 30) 1970, 1971, and 1973 for its Federal income taxes in the respective amounts of $9,660.54, $8,398.25 and $500, plus additions to tax under section 6653(a) in the respective amounts of $483.03, $419.91, and $27.50. By amended answers, respondent also set out an alternative position asserting deficiencies pursuant thereto of $11,587.16, $3,082.33 and $2,688.22 in the respective fiscal years. The cases have been consolidated for trial, briefs, and opinion.

The issues initially raised by the pleadings are: (1) whether petitioner may deduct $19,019.43 in taxable year 1970 and $26,434.05 in taxable year 1971 claimed as reinsurance expenses paid to Farila, N.V. (Farila);[2] (2) whether petitioner may deduct $50 in taxable year 1970, $1,110.52 in taxable year 1971, and $2,500 in taxable year 1973 claimed as expenses for interest paid to Anglo Dutch Capital Company (Anglo Dutch);[3] and (3) whether any part of any deficiency is due to petitioner's negligence or intentional disregard of the applicable rules and regulations under section 6653(a).

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[2] Petitioner claimed a deduction of $46,172.25 for "Bail Insurance Contracts" for its taxable year ending June 30, 1970, and $26,434 for "Reinsurance Costs" for its taxable year ending June 30, 1971. No similar insurance expense deductions were claimed for 1972 through 1975 (although a small insurance expense deduction was claimed for each year). The reasons given for the disallowances are that it has not been established that: a) the reinsurance transaction should be recognized as bona fide for tax purposes; b) the contract with Farila was valid and enforceable; and c) the amounts claimed as expenses were ordinary and necessary business expenses.

[3] Petitioner claimed total interest deductions of $105.92, $1,110.52, and $2,500 for its tax years ending June 30, 1970, 1971, and 1973, respectively. The reasons given for the disallowances are that it has not been established that: a) an

(footnote continued)

Respondent's basic position is that the insurance and interest transactions were simply documented "money movements," shams having no economic substance, thereby producing no actual, deductible expenses. Respondent argues in the alternative, by way of amended answers, that even if this Court finds that petitioner may deduct the claimed business expense payments for reinsurance in issue (1) above, nevertheless, petitioner may not deduct expenses in the respective amounts of $22,752.49 in taxable year 1970, $12,150.07 in taxable year 1971, and $9,719.19 in taxable year 1973 claimed (and originally allowed) for court costs, forfeitures, and skip-tracing expenses in each of those fiscal years. Respondent's denial of such deductions is on the ground that the expenses so claimed would have been subject to reimbursement under the reinsurance contract. Respondent has conceded entertainment expense deductions of $1,380.50 for the 1970 taxable year and $750 for the 1971 taxable year. Petitioner challenges all of respondent's positions asserting that form and substance are the same.

(footnote continued from previous page)
indebtedness was incurred; b) the amount claimed was paid or properly accrued; and c) the transaction giving rise to the indebtedness should be recognized for tax purposes.

These cases have a long and unusual procedural history, in the process producing various threshold issues which must be addressed prior to any consideration of the consolidated case on the merits. We now consider these preliminary matters.

PRELIMINARY FINDINGS OF FACT

Bail Bonds by Marvin Nelson, Inc. (petitioner or Bail Bonds) was a California corporation, chartered on June 19, 1969. During the taxable years in issue Marvin Nelson (Nelson) was the sole shareholder and president of petitioner. Nelson was a bail bondsman, licensed pursuant to the statutes of the State of California.[4] Petitioner was a cash basis taxpayer using a July 1 to June 30 fiscal year.

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[4] California Insurance Code section 1800 et seq. (West 1972). While it is stipulated that petitioner was incorporated, and there was testimony that the Secretary of the State of California approved petitioner's application for incorporation, California Insurance Code section 1810 (West, 1972) provides that "Only natural persons can be licensed under this chapter." There is no further evidence in the record regarding the incorporation of petitioner (including whether incorporation was sought under the "Professional Corporations" chapter of the Corporation Code of California section 13400, et seq.), any waiver or nonapplication of California Insurance Code section 1810, nor regarding the qualification of petitioner, as opposed to Nelson, personally, as a person licensed to sell bail bonds under California Insurance Code section 1800, et seq. However, petitioner's classification as an association taxed as a corporation for Federal income tax purposes is a function of Federal law, not state law. Section 7701; section 301.7701-1(c), 301. 7701-2, Proced. and Admin. Regs. Therefore, petitioner's qualification, vel non, under California Insurance Code section 1800 will not affect our treatment of it as an association taxed as a corporation in this case. See Kintner v. Commissioner, 216 F.2d 418 (9th Cir. 1954).

Petitioner timely filed its Federal corporate income tax returns for the years in question, claiming the deductions discussed above. Respondent denied the insurance expense and interest deductions, as well as the entertainment expense deductions, and determined the additions to tax in separate notices of deficiency dated July 19, 1973 (for the 1970 and 1971 taxable years in docket No. 7083-73) and September 19, 1975 (for the 1973 taxable year in docket No. 10026-75). The corporation timely filed petitions in this Court in each instance.

On August 4, 1978, petitioner, by its attorney Harry Margolis (Margolis), moved to amend both petitions to plead additional facts and claim the application of collateral estoppel in support of its position; that motion was denied.

On October 13, 1978, Margolis moved to consolidate more than 600 cases then on file and awaiting trial in this Court, including the two cases of petitioner herein. This motion was premised upon the grounds that respondent had acted illegally and in contravention of the Constitution of the United States in obtaining evidence against the taxpayers in those cases, all of whom were, or had been, law clients of Margolis, and that those taxpayers had been improperly selected for audit and arbitrarily subjected to adjustments. The motion was denied by order dated October 30, 1978. On September 10, 1979, petitioner filed amended petitions in both dockets, pursuant to leave of the Court, raising these same arguments, which respondent denied by answer. Respondent, on brief, has argued that the amended portion of the petition should be stricken, while petitioner seeks judgment on these grounds.

In June and September 1979, these cases were tried in California before Judge William Quealy. At that time a joint stipulation of facts, with attached exhibits A through AT and 1-13, was filed pursuant to Rule 91. A supplemental stipulation of facts later was filed to correct an arithmetic error in the original stipulation. After the cases were tried, briefed and submitted in 1979, but before any findings of fact were made or opinion written, Judge Quealy retired from the Court in 1980. These cases then were reassigned to Special Trial Judge Fred R. Tansill.

After receiving notice of reassignment, petitioner moved for a new trial. This motion was granted over respondent's objection, and the parties were ordered to stipulate to the fullest extent possible to all agreed facts, testimony, and exhibits before a second trial. A Second Supplemental Stipulation of Fact was filed with the Court on April 20, 1981. Attached thereto were documents labeled as exhibits D through BF (omitting exhibits F, S, U, W, Y, AB, and AG) and 1 through 14 (omitting exhibit 9), with reservations regarding some of the documents.

Prior to the second trial before this Court, each party filed a motion for an order to show cause why certain proposed stipulations of fact and documents should not be deemed admitted.

Hearings on these motions and the trial de novo were held in June, 1981. During those proceedings, the motions for show cause orders were rendered moot and discharged by order upon the parties' filing of a Third Supplemental Stipulation of Fact. This stipulation revised language in the previous stipulation which described exhibit BE, and further stipulated the admission of exhibit AF. A Fourth Supplemental Stipulation of Fact was filed on August 10, 1981.

Petitioner has objected to the admission of several of the documents attached to these stipulations as well as to several documents admitted at trial. Before and during the second trial, and over petitioner's objection which he maintains on brief, we ruled that all facts stipulated in the first trial and all exhibits received in evidence in the first trial remain admitted and part of the record of these cases. The Third Supplemental Stipulation also added language in the description of documents which were attached to both that stipulation and the original stipulation. The additional language had the effect of limiting respondent's stipulation to those documents, and respondent objects to the elimination of such additional language. We took this issue under advisement.

The record in this case also includes, by stipulation, some of the witnesses' testimony from the first trial. Additionally, prior to the first trial, the Court had granted a joint motion for the admission into that record of the testimony of Alfred H. Harris given during the trial of Alan B. Karme and Laila M. Karme

v. Commissioner, docket Nos. 3059-73 and 9798-74 (reported as Karme v. Commissioner, 73 T.C. 1163 (1980), affd. 673 F.2d 1062 (9th Cir. 1982)). At the second trial of these cases, this Court admitted the Harris testimony over an objection to such admission raised by petitioner. Petitioner maintains this objection in its brief.

THRESHOLD ISSUES

Against this convoluted background, we must first determine what evidence is properly before us prior to making any findings of fact based upon that evidence. In this process we must also consider whether petitioner's prayers for summary judgment, based upon the amended petitions, or its claimed defense of collateral estoppel requires judgment in its favor. Each of these matters now will be considered.

A. Amended Petitions

Petitioner argues that its amendments to the petitions comply with the standards of Federal pleading by making "a short and plain statement of [its] claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a).[5] In its amended petitions, petitioner alleged that it was not selected for audit, nor was the audit conducted, by a regular or proper procedure. Rather, petitioner claims, respondent had predetermined the adjustments to its returns as a result of the so-called "Bahamas Project," an IRS investigation into offshore tax shelters. Petitioner claims that, as a result of that investigation, clients of attorney Margolis were singled out for audit, which, it claims, violated the subject taxpayers' constitutional rights. Petitioner asks this Court to exercise "supervisory power over respondent's activities," to shift the burden of proof to respondent, which we treat as a motion to shift the burden of going forward with the evidence to respondent, and to find for petitioner summarily on the merits.

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[5] Petitioner should have cited our Rules 31(b) and 41(a) to the same effect.

As discussed above, we originally denied petitioner's motion to so amend its petition in 1978. The order denying that motion referred to our Memorandum Sur Order, dated October 27, 1978, in the case of *Karme*. Therein we decided a similar motion involving clients of Margolis and the "Bahamas Project," and we reach the same result in this case. It is the established rule of this Court not to look behind the notice of deficiency to consider the propriety of respondent's motives or procedures. E.g., *Jackson v. Commissioner*, 73 T.C. 394 (1979); *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324 (1974). Even if we may exclude evidence determined to have been obtained illegally, (in this regard see *Guzzetta v. Commissioner*, 78 T.C. 173 (1982)),the existence of such facts would not preclude us from considering the case on the merits of the admissible evidence. While petitioner has objected to the admission of some evidence in this case (see discussion *infra*), the amended petitions do not allege that any specific piece of evidence has been obtained in violation of the Fourth Amendment to the United States Constitution; no particular item or document was objected to on this ground. Rather, it is claimed that respondent's conduct of the "Bahamas Project" involved behavior which was in violation of the law and of petitioner's constitutional rights, and that the method of audit was arbitrary and illegal. Such claims do not allege facts which, even if true, would support a finding for petitioner in this Court. Cf. Church of Scientology of California v. Commissioner, 83 T.C. 381, 447-454 (1984).

For the same reasons stated in the Memorandum Sur Order in Karme,[6] we will only consider the issues in petitioner's case on their merits. Accordingly, respondent's motion to strike is granted to the extent that the amended petitions seek a summary decision in petitioner's favor, a shift in the burden of going forward, or exercise of this Court's "supervisory powers" based upon respondent's conduct of the "Bahamas Project" or the audit procedures in such cases.

B. Collateral Estoppel

Petitioner claims in the amended petitions[7] that determinative issues in this case already have been litigated in previous cases in this Court and that, pursuant to the doctrine of collateral estoppel, respondent should be precluded from raising those same issues in this case. Petitioner cites the opinions in the following cases as precluding respondent from raising the substance versus form argument in this case: Brock v. Commissioner, 59 T.C. 732 (1973); Abraham v. Commissioner, T.C. Memo. 1974-19; Estate of Cole v. Commissioner, T.C. Memo. 1973-74; Hill v. Commissioner, 63 T.C. 225 (1974); and Anglo Dutch Capital Company v. Commissioner, docket Nos. 6105-71, 4129-72, 3343-74, 9376-74, 10486-75, 7845-78, 311-79.

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[6] A copy of which will be attached to the record herein.

[7] It is procedurally proper to plead avoidance or an affirmative defense such as collateral estoppel. Rule 39.

In the recent case of Wright v. Commissioner, 84 T.C. 636, 639 (1985), we stated that "[t]he doctrine of collateral estoppel precludes relitigation of any issue of fact or law that is actually litigated and necessarily determined by a valid and final judgment." The doctrine, however, "must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged." Commissioner v. Sunnen, 333 U.S. 591, 599-600 (1948). The facts and issues with which we are concerned in this case are whether loans from Anglo Dutch to petitioner represent valid indebtedness, whether payments by petitioner to Farila represent valid business expenses, and whether Margolis effectively controls Farila, ABC, and Anglo Dutch. None of these issues was actually litigated and necessarily determined in the cases cited by petitioner. Hence, respondent is not collaterally estopped from raising these issues in this case.

In its brief, petitioner argued that the modifications made by Parklane Hosiery Company, Inc. v. Shore, 439 U.S. 322 (1979), and Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313 (1971), to the doctrine of collateral estoppel permit the application of collateral estoppel in the present case. We agree with petitioner that those cases allow the offensive use of collateral estoppel in certain circumstances and abandon the strict application of the doctrine of the mutuality of parties. Cf. McQuade v. Commissioner, 84 T.C. 137 (1985). We have, however, found that the facts and issues to be determined in the present case have not been litigated and previously determined in any of the cases cited by petitioner. Neither Parklane nor Blonder-Tongue would require or allow the use of collateral estoppel under these conditions.

Also, petitioner has moved to augment the record in this case by submitting the following additional documents and requesting us to take judicial notice thereof:

1. Findings of fact and conclusions of law by the Superior Court of the State of California in five cases which involve, as parties, the following individuals and entities: Douglas R. McAvoy; Margolis; Anglo Dutch; Aruba Bonaire Curacao Trust Company, Ltd. (ABC); Customcraft Construction Company; and World Minerals N.V. (Minerals);

2. Stipulations of facts and the "judgment" of this Court in the Cole, Brock, and Abraham cases, cited above; and

3. This Court's orders of dismissal and decisions in the following cases: Anglo Dutch Capital Company, a California Corporation v. Commissioner, Docket Nos. 6105-71, 4129-72, 3343-74, 10488-75, 7845-78 and 311-79. These cases were dismissed upon respondent's motion with decisions that there were no deficiencies in these cases. No findings of facts were made.

We hereby grant petitioner's motion to augment the record only to the extent that this Court will take judicial notice of the fact that findings of fact and conclusions of law were made in the referenced cases in the California Superior Court and that this Court has entered a decision in the Cole, Brock, Abraham, and Anglo Dutch cases. However, we are not bound by the California Court's findings since, for among other reasons, the same or similar issues were not addressed.[8] No findings of fact or conclusions of law were made in the Anglo Dutch cases in this Court, since they simply were dismissed upon respondent's motion. Thus, they are of no binding effect here. The decisions of this Court in Cole, Brock, and Abraham were based upon facts involving different transactions and resolved different issues than are involved in the present case. They also are of no binding effect here. Thus, to the extent that petitioner's motion to augment the record is granted, no additional facts or rulings are incorporated into the record here which are dispositive of any issue presented in the consolidated case.

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[8] See Horstmier v. Commissioner, T.C. Memo. 1983-409. Compare C.F. Malanka and Sons, Inc. v. Commissioner, T.C. Memo. 1979-187, affd. without published opinion 661 F.2d 913 (3d Cir. 1981), wherein we took judicial notice of a state court proceeding and certain ultimate facts determined therein, but not of disputable "adjudicative facts," citing Rule 201 of the Federal Rules of Evidence. The questions which need to be determined here were not at issue in the cases decided in the California Superior Court, nor confronted by this Court in the dismissed Anglo Dutch dockets.

Petitioner's motion to augment the record through judicial notice also is denied to the extent that petitioner would have us consider stipulations of fact in any case other than the the one presently before us. Rule 91(e) provides that a stipulation shall be binding "only in the pending case and not for any other purpose, and cannot be used against any of the parties thereto in any other case or proceedings." We shall abide by our own rules and limit stipulations to their proper scope. Therefore, no stipulation in any other case shall, without further stipulation here, be considered in the matter now pending.

C. Evidentiary Questions

Petitioner objects to the admission of certain exhibits which were attached to the stipulation of facts in the original trial of this case. Respondent objects if the document descriptions in the Third Supplemental Stipulation of Fact (which limit his agreement to admission of the documents) are not considered and the exhibits are admitted without qualification, pursuant to the initial stipulations.

Rule 91 establishes the requirement, form, and effect of stipulations. Subsection (e) thereof states, in pertinent part: "The Court will not permit a party to a stipulation to qualify, change, or contradict a stipulation in whole or in part, except that it may do so where justice requires." Accordingly, we require each party to show why "justice requires" that the stipulations they entered into should be changed.

Petitioner claims that so far as the Harris testimony was made part of the record in the first trial by joint motion of the parties,[9] the opportunity to confront and cross-examine the witness was denied. However, that was the same situation at the time the original stipulation was made, and no facts shown to us change the effect of that condition. Therefore, we conclude that, since petitioner is in the same position vis-a-vis the stipulated testimony as it was at the time of the stipulation, justice does not require that the stipulation be withdrawn.

We reach the same result regarding the admission into the record of exhibits attached to the original stipulation, despite the parties' supplemental stipulations. The supplements have the effect of withdrawing some of the exhibits originally stipulated, though others were added, and limiting respondent's admission regarding certain of the exhibits. Apparently, the parties did this under the impression that the second trial constituted a new case.[10] No findings of fact or conclusions of law were made after the first trial, so neither party can show a prejudicial effect resulting from the original stipulation. Consequently, we hold that all documents and exhibits admitted as part of the original stipulations, with the description there used, shall remain in the record of this case. Pursuant to Rule 91(e), all stipulations of fact submitted by the parties, plus all of the exhibits attached to each of the stipulations, shall be considered as part of the record in this case. Where a supplemental stipulation corrects an original stipulation, the latter shall be given effect. However, where a supplemental stipulation attempts to retract or would have the result of retracting or limiting a prior stipulation or exhibit attached thereto without agreement of the parties, such supplemental stipulation shall not be given effect.

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[9] We consider this to be a stipulation of testimony, thus we will apply the standards of Rule 91 to petitioner's current objection to its admission.

However, we hold otherwise where reservations regarding admissibility of an exhibit were made on the original stipulation. Respondent objected to the admission of exhibit AG (a schedule prepared for trial showing amounts due to Farila offset by amounts due from Farila), objected to the authenticity of exhibit 2 (the contract between Nelson and Farila), with the exception of the signature of Nelson, and objected to the authenticity of exhibit 11 (consisting of three promissory notes) with the exception of the signature of Nelson. We rule that each of the exhibits is admissible. In so doing we express no opinion at this time regarding the truth of the matters asserted therein or the validity of the transaction intended to be represented thereby. Those arguments effectively constitute respondent's position on the "form versus substance" question in this case, upon which we will rule, infra.

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[10] We do not find that the parties actually agreed to relinquish any benefit gained through the original stipulation. Therefore, we do not consider them to have agreed to change the stipulations, as such. Rule 91(e) does permit change in a stipulation by agreement of the parties. See the effect of the comparable Rule 36, Federal Rules of Civil Procedure, in Mangan v. Broderick and Bascom Rope Company, 351 F.2d 24 (7th Cir. 1965).

Petitioner also objects to the admission of bank records of Banco Popular Antilliano, N.V. (hereinafter "Banco Popular"), located in Curacao. The records were submitted through IRS agent Reller who testified that they were obtained from Banco Popular through the Netherland Antilles tax authorities. The records purport to show the circular nature of the transactions among entities which respondent claims were controlled by Margolis. Petitioner objects on grounds of authenticity, i.e., no competent witness has shown that the documents are what respondent claims they are, and hearsay, i.e., petitioner has been been unable to cross-examine anyone concerning either the creation of the documents or the transmittal of the documents to the IRS.

We addressed the same arguments in Karme, and ruled that the foreign bank records were admissible. We do the same here. It is noted that the United States Court of Appeals for the Ninth Circuit, in affirming our opinion in Karme, held that Fed. R.

Evid. 803(24) permits receipt of foreign bank records in evidence where, as here, they are material, probative and serve the interests of justice.

With the exception of exhibit BL, the exhibits to which petitioner objects were attached to the original stipulation. As we ruled, supra, the original stipulation and the documents appended thereto shall remain in this record. Additionally, the exhibits are admissible under Rule 803(24), Fed. R. Evid. The records are material and probative regarding the question of the structure, the form, and the substance of the transactions upon which this case centers. No more probative evidence is available because Farila is a non-party foreign entity, not subject to process of this Court. Certainly, the purpose of these rules and the interest of justice will be served best by admission of this evidence. By so doing we are able to scrutinize more closely the nature of the transactions which are the subject of this case. The inclusion of these exhibits in the stipulation of facts served as notice to petitioner as to the particulars of the documents and respondent's intent to use them.

Finally, we believe that the documents contain sufficient guarantees of trustworthiness to satisfy Rule 803(24), Fed. R. Evid., as an exception to the hearsay rule and Rule 901(b)(4), Fed. R. Evid., as to authenticity. Under the circumstances of having been requested under Article XXI of the Netherlands-United States Income Tax Treaty, 62 Stat. 1757, 1766, T.I.A.S. No. 1855 the form, printing, entries, and entities named on the documents before us convince us, upon careful examination and detailed consideration, that they are what they purport to be--accurately recorded bank records of entities involved in this case. We admit them into evidence, supported independently either on this ground or upon the reasoning that they were stipulated by petitioners in the first place. Therefore, there is no need for us to consider the "business records" exception to the hearsay rule, Rule 803(6), Fed. R. Evid., and the chain of custody of the evidence necessitated thereby.

We must reach a different result, however, regarding exhibit BL. That exhibit is a handwritten note, its author unknown. Although it was obtained by the same process as the other exhibits so challenged by petitioner, it is in a totally different form. Significantly, petitioner was not notified of its intended use prior to trial, as required by Rule 803(24), Fed. R. Evid. Although respondent has cited cases providing exceptions to this requirement, they are distinguishable. Respondent did not offer exhibit BL only in rebuttal of petitioner's presentation, as in United States v. Iaconetti, 540 F.2d 544 (2d Cir. 1976), nor had petitioner ever been in possession of the document, as in Furtado v. Bishop, 604 F.2d 80 (1st Cir. 1979), cert. denied 444 U.S. 1035, (1980) nor does the exhibit escape classification as hearsay as an admission under Rule 801(d)(2), Fed. R. Evid. While an "admission" encompasses a statement made by the agent of a party, there is no evidence here to indicate who wrote the note constituting exhibit BL.

Reference therein is made to "Adolphson," an employee of the Margolis office during this time, thus an agent of petitioner. Respondent speculates that exhibit BL comprises the notes of an employee of Banco Popular regarding a telephone call from Adolphson. Although this is possible, as even Adolphson stated at trial, he had no recollection of the conversation or the transactions allegedly the subject thereof. Therefore, it is at best speculation to decide that whoever wrote the note was doing so in the capacity of agent of petitioner. Based on these reasons, and despite the similarity of the information on exhibit BL to information in other exhibits, we must reject the offer of exhibit BL into evidence and give it no weight in our consideration of the facts of this case. All other documentary evidence is admissible, as discussed supra, and will be considered.

Having disposed of various preliminary matters, we now move to the substantive findings of fact relating to the merits. Because of the nature of respondent's disallowances and petitioner's defense of the form employed by the parties, it is necessary to delve deeply into the operations of petitioner, searching for the substance of transactions.

FINDINGS OF FACT[11]

Marvin Nelson, an individual, was a bail bondsman licensed in the State of California. In 1969 he incorporated his business as Bail Bonds by Marvin Nelson, Inc. (petitioner) with its principal place of business in Berkeley, California. Nelson was the president and the sole shareholder of petitioner during the years in issue. Nelson's attorney in 1969 was Arthur Wells, Jr. (Wells, Jr.), a California attorney. Wells, Jr. introduced Nelson to attorney Margolis in 1969 in order to incorporate the business and to prepare a tax plan.

Generally, a bail bondsman contracts with an authorized insurance company that will act as surety on the bonds posted by the bondsman. Under these surety arrangements, the bondsman acts as agent, posting bonds for the surety or insurance company which supplied the bond to the bondsman. Prior to incorporating Bail Bonds, Nelson contracted with several such insurance companies to act as surety for the bonds he wrote. Pursuant to these contracts, a specified percentage of fees collected by Nelson was required to be paid to the surety. In addition, a deposit of 1 percent of the bond was routinely required to be placed in a reserve account with the surety company. This reserve created a trust account controlled by the surety that was available in case of default by the bondsman in his dealings with the surety. At the termination of the surety contract, the reserve account was paid to the bail bondsman, less any outstanding amounts on which the surety was liable.

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[11] Various terms used herein are for descriptive purposes only and are not intended to convey legal characterizations the sufficiency of which are in issue here, viz interest, loan, expense, etc.

Nelson entered into such an insurance surety contract with Resolute Insurance Company on January 6, 1967. This contract remained in effect until February 1970. He then entered into an agreement with United Bonding Insurance Company. This agreement continued until November of 1970, when an agreement with Wilshire Insurance Company was entered into. All required reserve account payments were made to these companies when the insurance premiums were paid. The cost of these arrangements was $17 per thousand of bond purchase, with $16 thereof allocated to premium and $1 to the reserve account. Since Nelson charged his clients a fee of 10 percent of their bonds ($100 per thousand of bond purchase), these surety contracts cost him 17 percent of his bail bond income.

Both before and after incorporating his business, Nelson was personally engaged in obtaining clients, spending much of his time out of the office. He did none of the bookkeeping or maintenance of records himself. His bookkeeper was Tillie Chesney, and Patricia Miller (Patricia) was his secretary. Patricia married Nelson in 1972. She was trained in bookkeeping by Tillie Chesney. Patricia did the routine office work for Nelson and for Bail Bonds after its incorporation. Either Tillie Chesney or Patricia prepared checks for corporate expenses which

Nelson would sign on behalf of petitioner, without inquiry or question. Nelson relied on Tillie Chesney and Patricia, who in turn received direction from Wells, Jr., or Margolis, to pay expenses and keep necessary records for the transactions involving Anglo Dutch and Farila. Arthur Wells, Sr., (father of Wells, Jr.) an attorney and C.P.A., prepared petitioner's tax returns for the periods ending June 1969 through June 1973. He prepared these returns from books and records of petitioner and advised Tillie Chesney regarding the recording of items only for tax purposes. He was not involved in petitioner's regular record-keeping activities. Wells, Jr., was the attorney upon whom Nelson relied primarily for advice and direction regarding the day-to-day conduct of the bail bond business, although others were occasionally consulted. Nelson considered Margolis to be his attorney for tax purposes only, since Margolis was not familiar with the bail bonds business.

On May 11, 1969, Nelson signed an insurance contract (Reinsurance Agreement) with Farila.

Farila was a Netherlands Antilles corporation. Its managing director and president during the years in question was Dirk Kuijper; its vice president was C.B. Siebesma. These individuals also worked for Curacao International Trust Company (CIT), a Netherlands Antilles company organized by Dr. A.A.G. Smeets. CIT represented numerous corporations in that jurisdiction providing domicile, bookkeeping, accounting services, and corporate officers. Farila was such a company, domiciled in Curacao by CIT.

Farila was registered in the Netherlands Antilles as an investment company. Its Articles of Incorporation stated that its registered capital upon incorporation in December 1968 was $10,000 and that its business purpose was to deal in securities, other personal property, and realty. It filed income tax returns in the Netherlands Antilles in 1969 and 1970. Farila's only reported income in 1969 was $9,260 in interest and dividends; and in 1970 it had interest of $4,580, capital gains of $27,674.01, and "Non-U.S.A." commissions of $3,440.27. No payments by petitioner are reflected on these returns.

Farila was a "system entity" in the Margolis organization's "system." The Margolis law office, in the process of tax-planning for clients, dealt with various entities and arranged transactions between these entities, including foreign corporations and trusts set up and operated through CIT (such as Farila and ABC, whether or not set up by the Margolis office),[12] entities directly owned or controlled by Margolis (such as Anglo Dutch), and corporations, partnerships, trusts, and businesses set up, operated by, or invested in by his clients (such as Bail Bonds). In the case of foreign entities not directly controlled by Margolis, there was a high degree of cooperative support amounting to effective control.[13] All these entities were referred to by persons working in the Margolis' law office as "system entities," as they were operated by or through, or dealt with by, the Margolis organization or "system." In some instances, accounting records were kept and maintained in the Margolis law office. At the direction of an attorney from Margolis' office, these entities would transact with each other and with Margolis' clients or on behalf of those clients having accounts with those entities. A "money movement" occurred when, pursuant to directions from Margolis' office, funds were transferred between system entities, or from or through an account maintained at a bank used by Margolis (such as Banco Popular, Union Bank, or Barclays Bank).

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[12] Margolis was not a shareholder, officer, or director of any these companies. Employees of CIT filled these positions and capacities.

When a client of the Margolis office, or a "system entity," engaged in a transaction, a written record of that transaction would be made and kept by the Margolis attorney. This was called a "system account." These were not documents which reflected accounting procedures in the formal or traditional sense. Rather, they were an informal record of the money paid by the client "into" the system, transactions undertaken with that money or on behalf of that client, and money paid to the client "out of" the system. "Circulating" transactions were those in which funds passed among or between system entities, with no money coming into or going out of the system. Not all of these "system accounts" were available for entry into the record of this case. However, such records were kept by Margolis' office for Nelson, Farila, Anglo Dutch, and ABC and were part of the record in this case.

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[13] Compare Karme v. Commissioner, 73 T.C. 1163, 1173-1175 (1980), affd. 673 F.2d 1062 (9th Cir. 1982).

Money paid into the system by a client would be added to the client's account, and amounts paid out would be deducted.[14] Amounts paid as interest to a system entity would be recorded as paid into the system. In some cases, interest would accrue on a client's system account balance. In some instances, money "paid in" would be available to the client in the future or would reduce an existing deficit.

The directions for the activities undertaken by Farila for Margolis clients and system entities came from Margolis' office. His office would send drafts of letters and transactions to CIT ("planning memoranda") which would, in turn, prepare the requested documents verbatim on Farila stationery to be signed by an officer of Farila who was also employed by CIT. Margolis was a client of CIT. He effectively controlled the operations of Farila through the services of CIT and paid administrative fees to CIT for these services. Arrangements for contractual agreements, payment of expenses and other transfers of funds, and communications from Farila were accomplished at the direction of Margolis, usually by the use of the verbatim letters, or "planning memos."

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[14] The testimony at trial referred to a client's "credit" or "debit" to the system for amounts paid in and paid out. We do not use these terms, however, because, as the system accounting itself demonstrates, they were not "debits" and "credits" in the traditional accounting sense, and our use of them could create ambiguity or confusion.

The Reinsurance Agreement of May 11, 1969, between Nelson and Farila, provided as follows:

> ## AGREEMENT
>
> FARILA N.V., a Netherland Antilles Corporation, hereinafter referred to as "Insuror", and MARVIN NELSON, a married man, hereinafter referred to as "Insured", entered into this agreement effective as of March 1, 1969.
>
> The terms and conditions of this agreement are as hereinafter set forth.
>
> 1. Insured has conducted business as a sole proprietor, a licensed bail bond broker in the State of California, United States of America, with his primary place of business in Berkeley, County of Alameda, doing business in Alameda and surrounding counties. Insured is to incorporate the operation of the bail bond business under the laws of the State of California no later than July 1, 1969. This Agreement shall then be adopted by said Corporation and shall replace the present proprietorship guarantee in all respects.
>
> 2. The sole proprietorship as insured shall pay to insuror twenty per cent (20%) of the gross revenue of the sole proprietorship for the period commencing with the effective date of this Agreement, until its termination. The Corporation to be formed shall pay the same per cent of gross revenue within thirty days after the end of each calendar year so that payments for the sole proprietorship and the Corporation shall be brought current no later than January 31, 1970.
>
> 3. Premiums payable hereunder may be paid on an annual basis each January or may be paid currently for which there shall be allowed to the insured an immediate reduction in premium of five per cent (5%) of the total premium.

4. All Statements of Charges on bonds written during the life of the Agreement shall be supplied to Insuror within forty days after the posting of such bond in order for this Agreement to be effective. Deposit in the United States mail shall be considered to be delivery except that the requirement of proof of mailing shall be that of the insuror. There shall be no deduction from gross in any case where proper notice has been given.

5. In addition to the foregoing, Insured shall render to Insuror, upon request, an accounting of all business transacted.

6. Insuror shall pay to Insured all net losses suffered by Insured by reason of bail forfeitures and expenses connected therewith, the total of such losses within 90 days after notice to Insuror that Insured shall have been required to pay such loss. Insured shall promptly notify Insuror of any forfeiture of any bond. Insuror's liability for said losses shall not exceed $20,000.00 per person unless Insuror expressly consents thereto in advance in writing.

7. Insured shall do all things necessary to minimize risks of loss, including, but not limited to, exercising care regarding the writing of bonds, requiring collateral when appropriate, promptly undertaking to apprehend bonded persons who have caused forfeiture of their bond, and employing personnel to seek out and apprehend such persons. Insuror shall pay expenses of Insured incurred in preventing or exonerating forfeitures not to exceed $1000.00 per bond.

8. It is understood that Insured is required to place on reserve one per cent (1%) of the sum of all surety bonds written. Upon demand, at anytime after one year from the date of this agreement, or when gross premiums paid hereunder exceed $30,000.00, whichever is later, Insuror shall place on reserve for Insured all sums which Insured has been required to post through December 31, 1969, in order to free said sums to Insured for business purposes. Thereafter, Insured shall post or replace Insured's reserves semiannually.

9. Insuror shall extend to Insured a $500,000.00 cash bond reserve. Said cash bond reserve shall be available in increments of $100,000.00 each at the then prime rate of the Bank

of America. Such prime rate shall apply for a period of one year and shall be in addition to a charge of $5000.00 for each $100,000.00 of outstanding loan payable, and shall be payable annually. All borrowed funds shall be used forthwith and shall turn over not longer than every 270 days.

10. This Agreement shall terminate forthwith should any license or charter necessary to the operation of Insured's business be terminated or revoked. Insured shall give Insuror prompt notice of such event.

11. Insured may not assign, hypothecate or pledge this Agreement or any rights therein.

12. All notices shall be given to Insuror at Handelskade 8, Willemstad, Curacao, N.A. and to Insured at 1711 University Avenue, Berkeley, California.

dated: 5-11-69

FARILA N.V.

_____/s/__________________

Dirk Kuijper, President

______/s/_________________

Marvin Nelson

The Reinsurance Agreement did not require Farila to act as a direct surety on bonds sold by petitioner. Rather, it was to be secondarily liable if another insurance company (under contract with petitioner) would not pay under a bond or where petitioner became liable for a bond forfeiture. In those events, the condition precedent to Farila's liability required that a Statement of Charges be "supplied" to Farila within forty days after the posting of such bond by petitioner. The record here fails to show that any such Statement of Charges was ever "supplied" by petitioner or any of its employees or its attorney, Wells, Jr., to Farila. Thus, the potential liability of Farila under paragraph 4 of the Reinsurance Agreement was never made effective by a Statement of Charges from or on behalf of petitioner.

Section 6 of the Reinsurance Agreement provides that, in order to recover its losses, petitioner must send prompt notice of any bond forfeiture to Farila. Petitioner only reported one insurable loss to Farila, a $15,000 potential forfeiture occurring in July, 1970 that would become final in July, 1971 if petitioner did not locate the bonded person. No evidence was presented to show whether or not this amount was eventually recovered from Farila.

A letter dated March 2, 1971 sent by Wells, Jr. to Farila states that petitioner "has not bothered [Farila] with forfeitures not exceeding $5,000" because petitioner did not want "to make the contract so unfair that [Farila] might cancel" and that "when the contract was made, it was mainly to protect against large forfeitures." However, most of the bonds written by petitioner during the years at issue were for amounts less than $5,000. During the period the Reinsurance Agreement was in effect, petitioner continued to contract with other bail surety companies. Farila never reimbursed petitioner for its insurable expenses and forfeitures incurred.

Petitioner only made two premium payments to Farila. The first payment was made March 20, 1970 in the amount of $19,019.43. The second payment was made on May 12, 1971 in the amount of $26,403.05.[15] The books and records of petitioner do not reflect a calculation, pursuant to the agreement with Farila, to determine the 20 percent of the bond income amount due as premium payment. Neither Nelson, Patricia, Tillie Chesney, Wells, Jr., nor Wells, Sr. made such a computation. The record does not disclose how the amounts of $19,019.43 and $26,403.55 were determined. However, a handwritten note in petitioner's book and records reflects a prorated amount of insurance payments due for 5 months, based upon "20 percent of gross," to equal $7,138.20. It appears that this refers to the 5 months between July 1, 1971 and November 30, 1971. The note indicates that this and other expenses were not reflected on petitioner's profit and loss statement for those months.

Petitioner's gross bond premium income, forfeitures, and skip-tracing expenses paid for the calendar years ending December 31, 1970 through December 31, 1974 and for the partial years preceding and following those years were as follows:

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[15] Petitioner incurred a cable transfer fee of $30.50 on this transaction; petitioner deducted both this fee and the payment to Farila (totaling $26,434.05) as Reinsurance Costs on its taxable year 1970 return.

Period	Premium Income	20 Percent of Premium Income	Court Costs Forfeitures, and Skip-Tracing
7/1/69 - 12/31/69	$ 94,462.40	$ 18,892.48	$ 3,391.30
1/1/70 - 12/31/70	149,777.42	29,955.48	26,606.70
1/1/71 - 12/31/71	97,966.41	19,593.28	10,800.92
1/1/72 - 12/31/72	92,227.03	18,445.41	10,506.57
1/1/73 - 12/31/73	52,655.95	10,531.19	10,035.76
1/1/74 - 6/30/74	36,657.85	7,331.57	2,771.94
TOTAL	$523,747.06	$104,749.41	$ 64,113.29

Petitioner maintained its books and records on a fiscal year basis ending each June 30, while paragraphs 2 and 3 of the Reinsurance Agreement called for an annual accounting on a calendar year basis. These same items based on the petitioner's fiscal year were in the amounts as follows:

Year Ended	Premium Income	20 Percent of Premium Income	Court Costs Forfeitures, and Skip-Tracing
6/30/70	$171,408.94	$ 34,281.79	$ 22,752.49
6/30/71	128,883.98	25,754.80	12,150.07
6/30/72	92,673.71	18,534.74	8,289.75
6/30/73	68,288.74	13,657.75	9,719.19
6/30/74	62,473.20	12,494.64	10,841.20
TOTAL	$523,728.57	$104,723.72	$63,752.70

There was no evidence of termination of the Reinsurance Agreement by the parties. There was no written notice of termination submitted in evidence nor was there any testimonial or other evidence that such a termination had in fact occurred.

The cumulative amounts due from Farila more closely approximate the cumulative amounts owed to Farila in 1974 than in any other year after the year of last payment by petitioner (1971). However, there is nothing in the record of this case to show the recognition by petitioner of any such amounts due from or owed to Farila.

Aruba Bonaire Curacao Trust Company Limited (ABC) was another Netherlands Antilles corporation owned and operated by officers of CIT, and was also a "system entity." It was a trust management company, set up by CIT personnel, which managed numerous trusts for CIT clients. Margolis had a working relationship with ABC, as he had with several management employees of CIT, and he often recommended it as trustee to his clients. When engaging in transactions related to clients of Margolis, ABC would operate from planning memoranda, discussed supra, prepared at the Margolis office. Margolis or a member of his staff effectively controlled the transactions entered into by ABC, to the extent that such transactions related to Margolis' clients or their accounts.

On June 10, 1971, Nelson executed a power of attorney appointing Godfrey Johnson as his attorney to establish a trust with ABC as Trustee. A document styled "TRUST AGREEMENT" and an attached document entitled "BASIC TRUST AGREEMENT" were executed in the name of Nelson "by his attorney," Godfrey Johnson, and by Marie Denise Jobin, Vice President of ABC, on July 27, 1971. The trust was established with a contribution of $100.

Anglo Dutch, a California corporation, was also a "system entity." Its stock was owned by Harry Margolis and Walter Joe, the latter an employee of Margolis' law corporation (Margolis, Chatzky, Dunnett, and Muehlenbeck) during the years at issue. Anglo Dutch, controlled by Margolis' office, loaned money to clients of Margolis and to business entities which were related to or had dealings with such clients. The principal source of funds for Anglo Dutch was Alms, N.V. (Alms) a Netherlands Antilles corporation organized by A.L.M. In der Rieden. In der Rieden was also a senior employee of CIT.

Petitioner's books and records reflect receipt of loans from Anglo Dutch evidenced by notes in the amount of $15,000 on March 20, 1970 and of $25,000 on May 10, 1971. There were four promissory notes in favor of Anglo Dutch, for the signature of Marvin Nelson as president of Bail Bonds, which were issued as follows: March 17, 1970 for $15,000; August 26, 1970 for $5,000 (with a notation that it "Replaces" the first note); April 26, 1971 for $25,000; and April 26, 1972 for $25,000 (with a notation that it renews the April 26, 1971 note), all stating a 10 percent interest rate. The March 1970 and April 1971 notes are stamped "CANCELLED"; the August 1970 and April 1972 notes are stamped "PAID" as of February 19, 1971 and December 26, 1973, respectively. The August 1970 note for $15,000 was unsigned; all the other notes were signed by Nelson, as president of petitioner.

There is a dependent interrelationship between the loans received by petitioner from Anglo Dutch and petitioner's payments of reinsurance premiums to Farila and the parties have so agreed. Petitioner used these loan proceeds to transfer funds to Farila; $19,019.43 was so transferred on March 20, 1970 and $26,403.55 on May 12, 1971. The money that was transferred to Farila, ostensibly as payments on the Reinsurance Agreement, then moved back to Nelson and to Anglo Dutch.

The following table summarizes these transfers by date:

Date	
3/17/70	$15,000 note from petitioner to Anglo Dutch is executed.
3/20/70	Loan payable to Anglo Dutch for $15,000 is entered in petitioner's books.
3/20/70	Check from petitioner to Farila in the amount of $19,019.43.
3/20/70	Petitioner enters into its books the payment to Farila.
4/26/71	$25,000 note from petitioner to Anglo Dutch is executed.
5/10/71	Loan payable to Anglo Dutch for $25,000 is entered in petitioner's books.
5/12/71	Check from petitioner to Farila in the amount of $26,403.55.
5/12/71	Petitioner enters into its books the payment to Farila.

The $19,019.43 check paid by petitioner to Farila on March 20, 1970 was, on March 26, 1970, deposited into Farila's bank account at Banco Popular in Curaçao, Netherlands Antilles. On April 2, 1970 Farila transferred $28,897.65 from that account to the Wells and Chesney trust account at the Berkeley branch of the Central Valley National Bank, Berkeley, California. On April 10, 1970, the Wells and Chesney trust account disbursed three checks to Nelson personally, in the total amount of $25,397.65. On the same date, a check from the same Wells and Chesney trust account was drawn for $3,500 to Wells and Chesney in repayment of a loan to Nelson. Thus, the entire $28,897.65 was paid out to or for Nelson.

According to Wells, Jr., this April 2, 1970 transfer of $28,897.65 from Farila was a loan from Farila to Nelson made in response to his letter of March 20, 1970 to Farila. The letter stated that "the sums on deposit at Barclay's as of December 31, 1969 are $28,897.65 for Nelson as an individual and $9,685.25 for the corporation" and requested that $28,897.65 be made available to Nelson "pursuant to the terms of the agreement." The reference to Barclay's was intended by Wells, Jr., to refer to monies held in a reserve account which Nelson or petitioner was purportedly required to maintain at Barclay's Bank with one of their surety companies.

For the fiscal year 1970, petitioner's books show that reserve account payments were made to the First Valley Bank for a surety other than Farila. There was no evidence presented for the record to show that petitioner or Nelson ever maintained a reserve account at Barclay's Bank. There was no promissory note evidencing any loan from Farila to Nelson, nor could Nelson recall ever receiving a loan from Farila or ever repaying such a loan.

The second transfer of funds petitioner made to Farila circulated back to Anglo Dutch. On May 12, 1971, petitioner paid for a cable transfer of $26,403.55 to Farila. This check was deposited in Farila's bank account at Banco Popular on May 18,

1971. On the same day, $25,000 was transferred from Farila's Banco Popular account to the account of Anglo Dutch at Union Bank, Los Angeles, California. The latter transfer did not affect the balance in any bank account of either petitioner or Nelson.

Repayment of the first loan from Anglo Dutch, the one for $15,000, was made by petitioner in three $5,000 installments on June 10, 1970, August 25, 1970, and February 3, 1971. Repayment of the second loan from Anglo Dutch, the one for $25,000, was repaid by means of an elaborate money movement arranged by the Margolis office.

In 1973, two bank accounts were opened in the name of petitioner at Barclays Bank in Saratoga, California. On November 3, 1973, account number 00020-16963 (hereinafter "16963") was opened with a deposit of $100 advanced by the Margolis office. Nelson and Adolphson[16] had signature authority over the account. On December 5, 1973 account number 00020-10161 (hereinafter "10161') was opened with a $100 deposit from the Margolis office, Nelson and Adolphson again having signature authority. The $100 used to open each account was recorded on petitioner's books as a loan from "Harry Margolis, a Prof. Corp." On December 26, 1973 a check for $27,000 was written on account 16963 payable to Bail Bonds , signed by Nelson, and deposited in account 10161. At this point in time, petitioner's check record for account 16963 reflected a negative account balance ("-$27,000"). On that same date, two checks were drawn on account 10161--one check for $26,693 payable to Anglo Dutch and another for $300 payable to Harry Margolis for legal fees. On the following day, December 27, 1973, a check for $27,000 was deposited into account 16963. The source of funds for this deposit is not shown on either petitioner's records or the bank account records. Nor do petitioner's books and records reflect an increase in loans payable for this transaction.[17] However, the "system account" maintained by the Margolis office for ABC shows a loan of $27,000 to Marvin Nelson on this date. Nelson, however, was unable to recall a loan transaction with ABC or dealing with a trust account at ABC. No evidence was submitted to show that this amount was ever repaid to ABC.

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[16] A CPA employed by the Margolis law firm.

On February 4, 1974, a check for $100 was written on each account payable to Margolis, and both account 16963 and account 10161 were closed.

At trial, Nelson was unable to testify regarding these bank accounts, why they were opened, why Adolphson was authorized to sign checks on the account, the purpose of the checks described above, or the origin of the funds in the accounts. Nelson could not recall ever receiving a loan from ABC or ever repaying such a loan. There was no promissory note introduced to evidence such loan.

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[17] Although petitioner kept its books for tax and accounting purposes on the cash receipts and disbursements basis, it did maintain a separate account entitled Loans Payable in which borrowing transactions were recorded.

At the second trial, Nelson recalled that he transferred some money to a foreign trust set up by Wells, Jr. and Margolis. However, he did not recall when this occurred, nor how much he placed into the trust. There is no other evidence of record regarding the amount of property contributed to this trust, the transactions engaged in by ABC as trustee thereof, or any distributions made by the trust. Nelson was also unable to explain the purpose of borrowing from Anglo Dutch or why, in general, he included petitioner in the various transactions here at issue, including the Reinsurance Agreement with Farila. Nelson relied upon his attorneys, Wells and Margolis, to arrange the business dealings in which petitioner engaged, with the exception of the bail bond procedures and transactions themselves.

Evidence regarding the transfers of funds described above comes from various sources, both testimonial and documentary. While the information contained in the documents is consistent in many respects, there are some notable differences and inconsistencies.

There are discrepancies in the dates on which transactions are recorded. These, however, are mostly insignificant in time and can be accounted for by considering the hiatus between the initiation of a money transfer by one party and the receipt and recording of it by another.[18] In some instances, however, there are differences between amounts recorded by different parties, and the sources of funds.

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[18] However, the dates shown by our findings are significant to the year of the inclusion of a transaction in a particular tax year.

A substantial discrepancy exists in the recordation of transactions with Farila. On its fiscal year ending June 30, 1970 return, petitioner claimed a deduction of $46,172.25 for "Fees for Bail Insurance Contracts." This amount is based on a single payment of $19,019.43 to Farila and several payments totaling $27,152.82 to petitioner's general bonding agent. Respondent disallowed the deduction for bail bond insurance to the extent of the $19,019.43 paid to Farila on March 20, 1970. However, the Farila "system account" reflects an additional payment of $12,395.76 on January 27, 1970 by Nelson to Farila. The record in this case does not reveal how the additional $12,395.76 was paid into the "system", and petitioner's records do not account for this payment. There is no support in this record for a finding that an additional $12,395.76 was ever transferred from petitioner or Nelson to Farila.

Ultimate Findings of Fact

The Reinsurance Agreement between Bail Bonds and Farila lacked substance and generally was ignored by both parties. Payments ostensibly made to Farila by Bail Bonds for premiums under that Agreement are not deductible for federal tax purposes. The funds obtained from Anglo Dutch to make these premium payments were not valid loans creating obligations to pay deductible interest; in each instance these funds ultimately were returned without consideration to Anglo Dutch or to Nelson, personally. In connection with the foregoing, petitioner relied on the advice of attorneys Margolis and Wells, Jr.; Nelson, the president and sole stockholder of Bail Bonds, was unsophisticated in tax matters.

OPINION

Petitioner claims that its Reinsurance Agreement with Farila was valid and that the payments of $19,019.43 in 1970 and $26,434.05 in 1971 were required to be made under the terms of that contract and, hence, constituted ordinary and necessary business expenses. Petitioner maintains that those amounts were properly accounted for on its books and records and that the difference between the 20 percent of premium income required to be paid to Farila and the lesser amount actually paid was, in fact, a "premium adjustment" offset by Farila's nonpayment of losses and expenses. Thus, petitioner explains the apparent failure of the contracting parties to enforce the agreement as an offset, leaving them nearly in the same position as if the contract had been followed, with an amount owing to petitioner for the difference.

Further, it is petitioner's position that the loan arrangement with Anglo Dutch was valid and enforceable. As such, it maintains that the interest claimed to have been paid ($50 in 1970, $1,110.52 in 1971, and $2,500 in 1973) is deductible.

Respondent, on the other hand, would have us consider all of petitioner's transactions with "system entities" to be shams. Respondent's position is that petitioner did not deal at arm's length with any of these entities (Anglo Dutch, Farila, or ABC). Rather, it dealt with the "system" as a whole, with Margolis' office creating the facade of actual business transactions among these various entities by preparing documentation having the appearance of negotiated agreements and by manipulating the movement of money among them. Respondent maintains that petitioner had no actual obligation to make any payments to Farila or Anglo Dutch so long as it had a balance of money "paid in" to the system as a whole. Therefore, respondent concludes, none of the expenses claimed to have been incurred were ordinary and necessary business expenses or interest actually "paid," hence, they are not deductible.

Alternatively, respondent contends that if we determine that these expenses are deductible, the amount deducted as forfeitures and skip-tracing expenditures are not deductible since these amounts were reimbursable expenditures under the Reinsurance Agreement with Farila. Because we hold in favor of respondent on his original argument, we need not address his alternative position.

Petitioner entered into two loan arrangements with Anglo Dutch.[19] The first occurred on March 20, 1970, when petitioner borrowed $15,000; these proceeds were used to make up part of the $19,019.43 premium payment to Farila on March 26. The second loan occurred on May 10, 1971, when petitioner borrowed $25,000 from Anglo Dutch; these proceeds were used to make up part of the $26,403.55 premium payment to Farila on May 12. Because of the direct relation between petitioner's loans from Anglo Dutch and petitioner's payments to Farila, the validity of the loan arrangements (and, hence, the deductibility of the interest payments thereunder) will depend on the validity of the Reinsurance Agreement;[20] i.e., if the agreement is for a legitimate business purpose, so too should be the method of financing the premium payments. If, however, the Reinsurance Agreement lacks economic substance, the loan will also be tainted. Accordingly, we will first focus our discussion on the arguments that relate to the Reinsurance Agreement.

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[19] Petitioner executed two additional promissory notes evidencing loans with Anglo Dutch on August 26, 1970 for $5,000
(footnote continued)

Petitioner bears the burden of establishing the validity of its claimed deductions (Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a)), even when the challenge goes to the substance of the transaction.[21] In this case respondent concedes that

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and on April 26, 1972 for $25,000. These loans, however, are merely extensions of a portion of the original principal borrowed in the transactions on March 17, 1970 and on April 26, 1971. Therefore, we will treat these extensions as part of the original borrowings rather than as separate loan transactions.

[20] Thompson v. Commissioner, 66 T.C. 1024, 1053 (1976), affd. 631 F.2d 642 (9th Cir. 1980).

[21] On brief, however, petitioner contends that the presumption of correctness usually attached to respondent's determination of (footnote continued)

petitioner has made payments to Farila, but respondent questions the underlying purpose of those payments. Petitioner contends that its purpose in contracting with Farila was to obtain insurance on the bail bonds it had written, thereby limiting its exposure to the subsequent forfeitures; ostensibly, this is the purpose of the agreement. However, this contention is not supported by the facts as revealed at the trial.

It is a well-established principle of tax law that a party has the right to arrange his affairs to reduce the amount of his tax liability; but it is equally well-established that the substance of a transaction must govern its tax consequences regardless of the form in which the transaction is cast. Gregory v. Helvering, 293 U.S. 465 (1935). In applying these two principles to a particular factual problem, the test to be

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a deficiency should not apply in this case because to do so would require that petitioner prove a negative, i.e., that the transactions in question were not shams. In support of this contention, petitioner relies on Weimerskirch v. Commissioner, 596 F.2d 358 (9th Cir. 1979), revg. 67 T.C. 672 (1977). In that case, the Commissioner's determination of a deficiency in the taxpayer's income was based on unreported income from the sale of narcotics. The Ninth Circuit held that the Commissioner must offer "some substantive evidence showing that the taxpayer received income from the charged activity" and, hence, could not rely solely on the presumption of correctness. But where, as in this case, respondent questions the deductibility of an expense, the taxpayer retains the burden of proof. Karme v. Commissioner, 673 F.2d at 1065, affg. 73 T.C. 1163 (1980). In addition, respondent in this case has presented substantial evidence in support of his determination, evidence which challenges the documentary framework of the transaction, establishes the factual background against which the transactions occurred, and traces the flow of funds among the parties. Thus, the factual situation is entirely different from Weimerskirch. The presumption of correctness, therefore, remains.

used is not whether the motive or intent of the taxpayer on entering into the transaction was, partially or solely, to decrease or avoid his taxes, but is "whether what was done, apart from the tax motive, was the thing which the statute intended." Knetsch v. United States, 364 U.S. 361 (1960) (quoting Gregory V. Helvering, supra at 469). Section 162 allows a deduction for the ordinary and necessary expenses, reasonable in amount, incurred in the conduct of a business. United States v. Haskel Engineering & Supply Co., 380 F.2d 786 (9th Cir. 1967). However, the mere fact that a party is legally bound to make a payment is not determinative of the deductibility question. B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), modifying 54 T.C. 912 (1970), cert. denied 407 U.S. 934 (1972); The Atlantic Monthly Co. v. Commissioner, 5 T.C. 1025 (1945). Nor is the fact that the appropriate book entries were made controlling. Glasgow Village Development Corp. v. Commissioner, 36 T.C. 691 (1961); Yant Construction Co. v. Commissioner, a Memorandum Opinion of this Court dated October 27, 1950. "The payment in question is to be judged in light of all the terms and conditions of the agreement establishing the obligation to pay and all the facts and circumstances existing at the time the agreement was made." B. Forman Co., Inc. v. Commissioner, 453 F.2d at 1160.

In 1969, Nelson approached his attorney, Wells, Jr., for the purpose of incorporating his bail bonds business. At about that same time, Nelson, through Wells, Jr., sought the tax planning services of Margolis. Part of the tax plan developed by Margolis included the execution of the Reinsurance Agreement. Petitioner asserts that this agreement was designed to insulate it from forfeiture losses. Assuming that there was a tax motive leading to the execution of the agreement but disregarding that motive for now, we must look to the terms of agreement, the manner in which those terms were carried out, the circumstances surrounding its execution, and the interrelationship of the parties to determine if the result is that for which section 162 allows a deduction.

On its face, the Reinsurance Agreement purported to achieve petitioner's objective--shifting the risk of forfeiture from petitioner to Farila. However, when we consider the circumstances surrounding the Agreement and the treatment of the transaction by the parties, it becomes apparent that the Agreement was mere camouflage designed to disguise a scheme of creating deductions by shifting money back and forth from one party to another through various intermediaries, all of which acted under the effective control or direction of Margolis. As noted previously, although a "taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation." Zmuda v. Commissioner, 731 F.2d 1417, 1421 (9th Cir. 1984), affg. 79 T.C. 714 (1982).

Looking first at the treatment of the Reinsurance Agreement by petitioner and Farila, we note that virtually all of the significant terms were not carried out. Petitioner's premium payments to Farila were determined arbitrarily, without regard to the formula stated in the Agreement, and were not made within the due dates provided for in the Agreement. Petitioner failed to comply with the condition precedent that it provide a "statement of charges on bonds written" to Farila. As a result, Farila's liability to pay petitioner's forfeiture losses was never effectuated. Petitioner also failed to notify Farila of the forfeiture losses and skip-tracing expenses incurred. Petitioner attempted to explain this last failure by adverting to a letter from Wells, Jr. to Farila which stated that petitioner had "not bothered [Farila] with forfeitures not exceeding $5,000.00." However, Nelson testified that most of the bonds written by petitioner were in amounts less than $5,000. If the purpose of the Agreement was truly to protect against petitioner's exposure to forfeiture, then certainly the area of greatest risk was disregarded by petitioner. Furthermore, during the period petitioner was purportedly covered by the Farila contract, petitioner continued its policies with other surety companies. Petitioner never filed a bona fide claim against Farila, and Farila never reimbursed petitioner for any forfeiture losses or expenses incurred.[22]

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[22] Petitioner contends that Farila did reimburse petitioner for losses--not by sending a reimbursement check, as provided for in (footnote continued)

Thus, in exchange for the payments to Farila, petitioner received nothing in return. In sum, then, it appears that other than alleged premium payments to Farila, nothing of substance called for in the Agreement actually occurred.

As clearly indicated by these facts, petitioner acted as though it had never entered into the Reinsurance Agreement. By tracing the flow of funds after payments were made to Farila, we can more readily discern what was actually accomplished by the parties involved.

On March 20, 1970, petitioner borrowed $15,000 from Anglo Dutch. On March 26, petitioner paid a premium of $19,019.43 to Farila. On April 2, Farila transferred $28,897.65 to the Wells and Chesney Trust Account at Banco Popular. This entire trust account balance was then disbursed, $25,397.65 going directly to Nelson and $3,500 to Wells and Chesney as repayment of a debt by Nelson. Petitioner could not explain the purpose of the transfer from Wells & Chesney to Nelson. We find that the only adequate explanation is that this was part of the pre-arranged transfer of funds designed to produce a corporate level deduction for petitioner with the monies transferred ending up

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(footnote continued from previous page)
the agreement, but by allowing credit against premiums due in subsequent years. However, petitioner failed to submit any evidence that such a credit was given by Farila or that petitioner took such a credit into account in determining future payments under the contract. Additionally, there is nothing in the record of this case that a claim was ever asserted by petitioner against Farila for the alleged "balance owed" of $4,786.86.

in the hands of its sole shareholder. Thus, the monies were merely passed from one participant in the Margolis system to another.

On May 10, 1971, petitioner borrowed $25,000 from Anglo Dutch. On May 12, petitioner paid a premium of $26,403.55 to Farila. On May 18, Farila then transferred $25,000 to Anglo Dutch. Thus, the monies traveled in a circle and petitioner has shown no purpose for this circuitous transfer. Petitioner's loan from Anglo Dutch was repaid in 1973 with the proceeds of a loan from ABC to Nelson; however, the loan from ABC did not appear on the books of Nelson or petitioner nor was any evidence of such a loan introduced. The loan simply disappeared, and Nelson could not recall ever arranging or receiving any loan from ABC.

Another fact which leads us to question the validity of the Reinsurance Agreement is petitioner's inability to explain how the parties arrived at the requirement stated in the Agreement of a premium payment of 20 percent of gross revenue. With the advantages of hindsight, we can now see that payments based on this amount would be well in excess of petitioner's loss exposure for the years 1969-1974. We do not have records for prior years to show whether this percentage may have been based on the history of the sole proprietorship's losses. It is clear, however, that neither Nelson, nor anyone in his office, nor Wells, Jr. questioned the adoption of this 20 percent figure. We find the blind acceptance of this percentage to be understandable when we consider, first that whatever amount was inserted in the agreement was of no real consequence because any amount paid would merely circulate from Farila back to petitioner's sole shareholder or to ABC, which supplied the largest portion of the payments, and, second, that the 20 percent figure, although stated in the Agreement, was completely disregarded by petitioner in determining the actual payments, arbitrarily made.

It is apparent that petitioner's transactions with Farila "did not appreciably affect [its] beneficial interest except to reduce [its] tax." Knetsch v. United States, 364 U.S. at 366, quoting from Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (dissenting opinion). Clearly, there was nothing of substance to be realized by petitioner from this transaction other than a tax deduction.

We are further persuaded that these transactions are without substance when we consider the manner in which they were arranged. Without restating the relationship between the parties, which is fully described in the findings of facts, suffice it to say that the linchpin in this arrangement was Margolis and the Margolis office. Neither petitioner nor Nelson previously had dealt with or had known of Anglo Dutch, Farila, or ABC. However, through the Margolis Office, petitioner became an active participant in this system. The Margolis office owned and controlled Anglo Dutch and exercised effective control over Farila and ABC. It was Margolis' office which drafted most of the provisions of the Reinsurance Agreement, and his office arranged petitioner's own transactions in this case down to the minute details of providing petitioner's bookkeeper with the appropriate book entries and monitoring the movement of funds among the parties.

It is clear, therefore, that the transactions here involved were part of an elaborate, well-orchestrated and pre-arranged money movement, the sole purpose of which was to create the substantiation needed to support the deductions claimed.[23] This is not a sufficient base on which to support a business expense deduction. Knetsch v. United States, supra; Audano v. United States, 428 F.2d 251 (5th Cir. 1979). Hence, petitioner may not deduct the payments made on the Reinsurance Agreement.

Petitioner argues alternatively that if the agreement with Farila is held invalid, petitioner should be entitled to deduct the "net unrecovered payment made by petitioner to Farila." It would appear that petitioner computes this amount as the amount of its actual forfeiture losses, court costs, and skip-tracing expenses, less the "credits" (see footnote 21, supra) given by Farila against premiums not paid. As support for its position, petitioner cites Protzmann v. Commissioner, 276 F.2d 684 (1st Cir. 1960), vacating and remanding a Memorandum Opinion of this

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[23] Additionally, we note that the risk of loss here had not been effectively shifted. Compare Humana Inc. and Subsidiaries v. Commissioner, T.C. Memo. 1985-426, and cases cited therein.

Court, which stands for the proposition that when a claim is disputed and a settlement is made, the amount not recovered is allowable as a loss.

Petitioner's reliance on Protzmann is misplaced. The taxpayer in that case entered into a bona fide business transaction, and the loss incurred resulted from this transaction. By contrast, petitioner's transactions with Farila are shams. The consequence of this finding is that, in an economic sense, there was no agreement with Farila; hence, the payments to Farila and "credits" from Farila are not recognized for tax purposes. Accordingly, these amounts are neither deductible nor includable by petitioner. There was no real loss or expense; therefore, petitioner may not deduct any "net unrecovered payment."

Since the Reinsurance Agreement with Farila is without substance, we find that the loans from Anglo Dutch are also lacking in substance. Petitioner, however, contends that because the form of the loan agreements was proper, these transactions should be valid. We do not agree. We must look to the entire transaction to see if it achieves the purpose that the statute intended. Knetsch v. United States, supra. These loans were obtained for the purpose of financing the Reinsurance Agreement, and proceeds merely circulated through various intermediaries as part of the scheme to create expense deductions for petitioner and to funnel cash into the hands of its sole shareholder.[24] Thus, the substance of these transactions is inextricably linked to the Reinsurance Agreement. We, therefore, find the loans to be without economic substance. Hence, petitioner may not deduct any amount paid as interest to Anglo Dutch.

Additions to Tax under Section 6653(a)

We consider, finally, whether petitioner acted negligently or with intentional disregard of the rules and regulations in claiming the deduction disallowed herein. Petitioner has the burden of proving that respondent's imposition of the addition to tax under section 6653(a) is erroneous. Enoch v. Commissioner, 57 T.C. 781 (1972). Petitioner must show that it "made reasonable inquiry" as to the income tax validity of its actions. Zmuda v. Commissioner, 79 T.C. 714 (1982), affd. 731 F.2d 1417 (9th Cir. 1984).

The record in this case establishes the fact that petitioner relied on its attorneys, Wells, Jr., and Margolis, to implement the tax planning here involved. Wells, Sr., prepared petitioner's tax returns for some of the years at issue.

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[24] In Saviano v. Commissioner, 765 F.2d 643 (7th Cir. 1985), affg. 80 T.C. 955 (1983), the 7th Circuit stated: "The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly. That is what we have done in this case and that is what taxpayers should expect in the future."

Further, much of the information entered into the books and records of petitioner by the bookkeepers was supplied by these individuals. Under these particular circumstances, petitioner's reasonable reliance on counsel does excuse it from liability for the addition to tax under section 6653(a). Hill v. Commissioner, 63 T.C. 225 (1974), affd. 551 F.2d 313 (9th Cir. 1977), without published opinion.

In asserting the additions to tax against petitioner, respondent relied on Bailey v. Commissioner, 21 T.C. 678 (1954) and Perrett v. Commissioner, 74 T.C. 111 (1980), affd. without published opinion 679 F.2d 900 (9th Cir. 1982); however, those cases are clearly distinguishable from the present case. Bailey involved the negligent failure of the taxpayer to review his return from which a substantial item of income had been omitted by the preparer. The present case, by contrast, does not involve an omission from the return but raises the question of the proper income tax treatment of complex transactions. Perrett involved the imposition of additions for negligence against a tax specialist for engaging in transactions he should have realized lacked substance for tax purposes. In the present case, petitioner was justified in relying solely on the advice of its attorneys and accountant since neither petitioner nor Nelson was a tax expert. Nelson, president and sole stockholder of petitioner, was generally unsophisticated in tax matters and depended implicitly upon his advisors. We think petitioner "made reasonable inquiry" under the facts and circumstances of this case.

Respondent is sustained on the reinsurance and the interest expense adjustments but not on the addition to tax under section 6653(a).

An appropriate order
will be issued.

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COMPLETED

T. C. Memo. 1986-24

UNITED STATES TAX COURT

DAVID HOCHMAN, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 25862-83. Filed January 22, 1986.

P was a casual, i.e., nonprofessional gambler, whose gambling losses exceeded his winnings in 1980. He was also a taxpayer who could be claimed as a dependent on the return of another. *Held*, P's gambling losses are items of itemized deduction, limited as provided in sec. 165(d), I.R.C. *Held further*, P was entitled neither to the zero-bracket amount nor to any itemized deductions in computing his taxable income, under sec. 63, I.R.C., under the facts of this case.

Otto J. Scerbo, for the petitioner.

Robert B. van Grover and *Frank Agostino*, for the respondent.

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MEMORANDUM OPINION

KÖRNER, *Judge*: For the calendar year 1980, respondent determined a deficiency in petitioner's income tax in the amount of $266. By amendment to his answer, filed by leave of Court in order to conform the pleadings to the proof, see Rule 41(b),[1] respondent claimed an additional deficiency for 1980 in the amount of $63, pursuant to section 6214(a). After concessions, the issues which we must decide involve the correct application of section 165(d) in computing the taxable income from wagering of a casual and nonprofessional gambler. The case was submitted on a fully stipulated set of facts and exhibits under Rule 122, which are incorporated herein by this reference and form the basis of our findings herein.

Petitioner was a resident of Clark, New Jersey, at the time of filing his petition herein. For the year 1980, petitioner filed an income tax return as a single individual.

At various times during the year 1980, petitioner gambled on horse races being run at various tracks. He was not in the trade or business of gambling, but was a casual or recreational gambler.

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[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

In the year 1980, petitioner made various bets on various horses in various races at various tracks on the following dates, and with gross winnings and losses as follows:

Date		Winnings[2]	Losses[3]
January	1	$1,164.60	$ 212.00
January	6	-	245.00
January	8	-	85.00
January	15	-	106.00
March	6	-	100.00
March	7	247.00	135.00
March	28	-	66.00
April	22	-	100.00
May	23	-	318.00
August	28	-	120.00
September	12	78.80	210.00
TOTALS		$1,490.40	$1,697.00

Petitioner's gambling losses exceeded his gambling winnings for the year 1980. In his income tax return, petitioner reported no income or losses from gambling, but reported wages of $1,534 and interest income of $1,842.74. Petitioner claimed no itemized deductions in his income tax return. He could have been claimed as a dependent on his parent's return. In accordance with the instructions on Schedule TC of his 1980 return, therefore, petitioner reduced the zero-bracket amount attributable to him in

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[2] The "Winnings" column is stated in gross, i.e., the full amount of the payoff on the winning ticket, including the price of that winning ticket.

[3] The price of the winning ticket or tickets on January 1, March 7 and September 12 is apparently included in the total figure shown for this column for the day. The figure for each day also includes the purchase price of the losing tickets.

1980 under section 63(d)(2), in the amount of $2,300, by $1,534, representing his earned income for the year. This resulted in a net figure of $766, which, when added to the reported income, produced a figure of $4,142.74, upon which petitioner computed a tax of $116. Petitioner claimed credit for $232.60 of income tax withheld at the source on his gambling winnings, and therefore claimed an overpayment of $116.60.

Upon audit, respondent determined, inter alia, that petitioner had realized taxable gambling winnings of $1,164 in 1980, and increased petitioner's taxable income accordingly. By amended answer, and to conform with the facts as stipulated by the parties, respondent claimed an increased deficiency based upon additional taxable gambling winnings of $326.40.

Petitioner's attack herein is based upon two broad propositions:

(1) Petitioner contends that his gambling losses may be offset against gambling winnings, at least to the full extent of the latter, and that no reportable gross income, within the meaning of section 61 of the Code, is derived unless gambling winnings exceed gambling losses. Petitioner thus argues that his gambling losses are not an item of itemized deduction, but rather that they are in the nature of a "cost of goods sold," which are to be offset against gross receipts from gambling in order to arrive at gross income in the first instance.

(2) Petitioner further contends that the operation of section 63 in this case is to deny him any deduction for his gambling losses, even if viewed as itemized deductions.

We treat each of these points of argument separately.

(a) The Nature of Gambling Losses

Although early cases, decided prior to the enactment of section 23(h) of the Internal Revenue Code of 1939, were not entirely clear on the question whether a gambler's losses should be considered as an item of itemized deduction (to be subtracted from gross income in order to arrive at net income), or rather as an item of cost of goods sold (to be excluded from gross receipts in arriving at gross income), see McKenna v. Commissioner, 1 B.T.A. 326 (1925), and Estate of Scaife v. Commissioner, 1 B.T.A. 338 (1925), the weight of authority now appears to be that although all gamblers must include their winnings in gross income under section 61, a professional gambler, i.e., one engaged in the trade or business of gambling, may aggregate his winnings and losses and take the latter as a deduction in arriving at adjusted gross income under section 62(1). Groetzinger v. Commissioner, 771 F.2d 269 (7th Cir. 1985), affg. 82 T.C. 793 (1984); Ditunno v. Commissioner, 80 T.C. 362 (1983), appeal dismissed (6th Cir. 1983); Gajewski v. Commissioner, 84 T.C. 980 (1985); Stein v. Commissioner, T.C. Memo. 1984-403.[4] In the case of a taxpayer not engaged in such trade or business, however, his losses are allowable as itemized deductions only against his adjusted gross income for the purpose of arriving at taxable income, pursuant to sections 63(b) and 63(f). *Winkler v. United States*, 230 F.2d 766 (1st Cir. 1956); *Groetzinger v. Commissioner*, *supra*; *Gajewski v. Commissioner*, *supra*; *Stein v. Commissioner*, *supra*. In either case, however, the deductions which a taxpayer may take on account of gambling losses may not exceed his gambling gains. Section 165(d).[5] *Humphrey v. Commissioner*, 162 F.2d 853 (5th Cir. 1947), cert. denied 322 U.S. 817 (1947), revg. a Memorandum Opinion of this Court; *Gajewski v. Commissioner*, *supra*; *Offutt v. Commissioner*, 16 T.C. 1214 (1951). In the case of the casual gambler such as this petitioner, therefore, it is clear that the deduction allowed by section 165(d) is an item of itemized deduction, section 63(f), to be used, not to exceed the amount of

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[4] The one possible exception to the above statement may be Winkler v. United States, 230 F.2d 766 (1st Cir. 1956), where the Court of Appeals appeared to hold that, in the case of a
(footnote continued)

(footnote continued from previous page)
professional gambler, gambling losses might, at least to some extent, be viewed as in the nature of cost of goods sold, rather than as a trade or business expense, and were therefore to be excluded from gross receipts in arriving at gross income. Whatever the full extent of the rationale in *Winkler v. United States*, *supra*, may be, it clearly has no application to the present case, since it applies only to the case of a taxpayer engaged in the trade or business of gambling. It is stipulated in the instant case that petitioner was a casual, i.e., nonprofessional gambler.

[5] Sec. 165(d) reads as follows:

> (d) Wagering Losses.--Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

gambling winnings reported as part of his adjusted gross income (as defined in section 62), for the purpose of arriving at taxable income under section 63(b).

There is one aspect of the instant case, however, which, although not clearly delineated nor briefed by either party, should be addressed.

Our findings of fact reflect petitioner's "winnings" and "losses," exactly as stipulated by the parties. It appears clear from that stipulation, however, that petitioner's "winnings" were stated in gross, i.e., the gross "payoff" to petitioner, including the price of the winning tickets. The price of such winning tickets was further included among the price of the losing tickets under the column for "losses." Even in the case of a casual gambler such as this petitioner, who had no "cost of goods sold," or trade or business deductions - because he was not engaged in a trade or business - a distinction of principle must be made. Although the power of Congress to tax income is very broad, and although section 61 is intended to reach and tax all income, from whatever source derived, Glenshaw Glass Company v. Commissioner, 348 U.S. 426 (1955), and although deductions are a matter of legislative grace, to be bestowed or withheld by Congress, New Colonial Ice Company v. Helvering, 292 U.S. 435 (1934), gross income still does not include the return of capital. The latter is an exclusion from gross receipts, and its allowance is not a matter of legislative grace, but rather a matter of determining the true gross income which constitutionally may be taxed. Eisner v. Macomber, 252 U.S. 189 (1920); Doyle v. Mitchell Brothers Company, 247 U.S. 179 (1918); Sullenger v. Commissioner, 11 T.C. 1076 (1948); see 1 Mertens, Law of Federal Income Taxation, sections 5.06, 5.10 (1985).

To the extent that the cost of his winning ticket is included in the payoff which petitioner receives at the cashier's window on a winning race, therefore, petitioner has only recovered his capital, and is entitled to exclude the amount of that winning ticket from his gross receipts in order to arrive at gross income within the meaning of section 61. Such recovery of capital, however, would clearly not include the cost of tickets which did not win. The latter items were separate wagers, made without reference to the winning wager, and are allowable only as permitted by section 165(d).6/

To the extent of the cost of his winning ticket or tickets, therefore, petitioner would theoretically be entitled to exclude such cost from his gross winnings in order to arrive at gross income under section 61 and adjusted gross income under section 62. In the instant case, however, the facts do not enable us to identify the amount of the cost of those winning tickets, since they were grouped into the column of "losses," which included the

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6/ As we have previously noted, the question whether a different approach should be applied to one engaged in the trade or business of gambling is one which we do not reach in this case. Cf. Winkler v. United States, supra; Gajewski v. Commissioner, 84 T.C. 980 (1985). See footnote 4, supra.

cost of losing tickets. Petitioner therefore failed to carry his necessary burden of proof with respect to these items, and we must uphold respondent's determination in treating the entire amount of his winnings, as stipulated by the parties, as being his gross income from gambling in 1980.

(b) The Allowability of Petitioner's Gambling Losses Herein

Holding, as we do, that petitioner's losses, represented by the cost of losing tickets are allowable only as an itemized deduction under section 165(d), in an amount not to exceed petitioner's adjusted gross income from gambling, we examine what happened in the instant case.

In his return for 1980, petitioner did not itemize his deductions. Absent such an election, and unless his itemized deductions exceeded the applicable zero-bracket amount, he would therefore normally not be entitled to claim itemized deductions. Sections 63(g)(1) and (g)(2). He was, however, to be treated as having made such an election, since, as stipulated by the parties, he was entitled to be claimed as a dependent in his parent's return for that year. Section 63(g)(3). Since such excess itemized deductions (as disclosed by this record) were his gambling losses, limited by section 165(d) to the amount of $1,490.40 (his adjusted gross income from gambling, as stipulated by the parties), and since such amount was less than the zero-bracket amount allowable to petitioner for that year ($2,300), petitioner was tentatively entitled to use only the zero-bracket amount in computing his tax. Section 63(d). Petitioner's adjusted gross income, however, after having been reduced by the sum of his excess itemized deductions (there were none), his personal exemption, and any direct charitable deductions (there were none), then had to be increased by his "unused zero-bracket amount (if any)," as provided by section 63(b). In petitioner's case, since his earned income ($1,534) exceeded his itemized deductions, his unused zero-bracket amount was to be computed by reducing the zero-bracket amount of $2,300 by such earned income, as provided by section 63(e)(2). Such computation, as correctly shown in petitioner's return, produced the amount of $766 which was correctly added to his taxable income.

Petitioner complains that this had the effect of denying him all deductions under section 165(d) on account of his gambling losses. This is literally true, but it is also clear that this is the result which Congress intended, not only as to gambling losses but as to any other type of itemized deduction in the case of a petitioner such as this one who could be claimed as an exemption on someone else's return. The clear congressional purpose was to deny such taxpayers, who had no itemized deductions in excess of the zero-bracket amount, the benefit of such zero-bracket amount, except to the extent that the zero-bracket amount was exceeded by the taxpayer's itemized deductions or his reported net income, whichever was greater. Section 63(e)(2). In this, petitioner's losses from gambling stood on the same footing as any other item of itemized deduction otherwise allowable to him. This was in fact the computation which petitioner used in his return, and we find it correct.

Because of concessions not in issue herein, as well as the amendment of respondent's answer to claim a larger amount of deficiency,

Decision will be
entered under Rule 155.

742-B Ju 11.7/2:1986-25

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T. C. Memo. 1986-25

UNITED STATES TAX COURT

JAMES E. MOWEN AND DIANE M. MOWEN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 18501-84. Filed January 22, 1986.

James E. Mowen, for the petitioners.

Robert Miller, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KORNER, *Judge*: Respondent determined a deficiency for the calendar year 1980 against petitioners for income tax and self-employment tax in the amount of $58,392, plus additions to tax under section 6653(b)[1] in the amount of $29,196. We are called upon to determine whether petitioners understated their taxable

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[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

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income in the year 1980, resulting from their dealings in precious metals in that year, and whether any such understatement of their income was due to fraud within the meaning of section 6653(b).

FINDINGS OF FACT

Petitioners James E. Mowen (hereinafter "James") and Diane M. Mowen (hereinafter "Diane"), husband and wife filed a joint income tax return for the year 1980. At the time of filing of the petition herein, petitioners were residents of Hagerstown, Maryland.

During 1980, James had full time employment with an undisclosed outside employer, while Diane, who had one infant child and another "on the way," was apparently not employed.[2] In August 1980, James, assisted in part by Diane, began to engage in buying and selling precious metals, in the form of coins, jewelry and other items containing gold and silver. This activity apparently continued until the end of January 1981, when it was terminated. In August, September and the early part of October 1980, James placed advertisements in a local newspaper in Cumberland, Maryland, advertising that he would pay cash for silver and gold coins, or other articles containing gold and silver. In this period, he made 26 round trips by automobile to Cumberland, Maryland, to carry on this enterprise, staying for various periods of time and purchasing items which were offered to him. The distance from Hagerstown to Cumberland is 68 miles. In such travel, James incurred automobile expenses of $707.20. In October 1980, he shifted his buying activities back to Hagerstown, Maryland, placing similar advertisements in the local newspaper there, and continued this activity through January of 1981. All purchases were made in cash.

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[2] James' wages were reported in petitioners' joint income tax return, and are not here in issue.

The purchases made by James, whether in Cumberland or in Hagerstown, were periodically taken to the Gaithersburg Coin Exchange Inc., of Gaithersburg, Maryland, by James (or his brother Mark Mowen, on James' behalf) and were sold. Twenty such round trips by automobile were made in 1980. The distance from Hagerstown to Gaithersburg is 49 miles. In his travel between Hagerstown and Gaithersburg, James incurred automobile expenses of $392.00.

In advertising for the purchase of coins and precious metals in 1980, James incurred expenses of $9,473.

James had gross receipts from the sale of coins and precious metals to the Gaithersburg Coin Exchange, Inc. in the year 1980 of $124,906. Diane kept a record of purchases of coins, gold and silver in a hard cover notebook, which was stored in the basement of petitioners' home, together with other records of the enterprise. Prior to the commencement of this case, such records had become mildewed and watersoaked because of wet conditions in the basement. All such records were destroyed because of their condition, but Diane made a handwritten copy of the record of purchases before destroying that record, showing an itemized list of each item purchased, a description of the item and the price paid therefor. Although this record purported to cover the entire period of James' operations -- August 1980 through January 1981 -- no dates were shown as to individual purchases. The total cost of goods sold for the period was $140,219.60. The cost of goods sold in 1980 was $116,849.66.

At the end of the year 1980, petitioners determined that they had suffered a net loss from their precious metals operation. No gross receipts or gross income from James' dealings in precious metals were disclosed in petitioners' 1980 return. Likewise, no deductions or net loss from these operations were claimed.

Upon audit, and in the absence of what he considered to be adequate records, respondent determined that the entire amount of $124,906 of gross receipts, as above, constituted unreported taxable income, and accordingly determined a deficiency of tax in 1980 of $58,392, including self-employment tax in the amount of $230. Respondent further determined that petitioners' omission of the precious metals activity from their joint return was fraudulent within the meaning of section 6653(b), and determined a 50-percent addition to the tax accordingly.

Petitioners suffered a net loss from their precious metals operations in 1980.

OPINION

Our first task in this case is to determine whether petitioners had unreported taxable income in 1980 from their precious metals operation in the amount as determined by respondent, or in any amount. Respondent's determination of this matter in his statutory notice is presumptively correct, and petitioners bear the burden of proof to show error therein. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Furthermore, where a taxpayer refuses or fails to supply records for examination with respect to his income, respondent is given great latitude and may use any reasonable method to reconstruct income. Section 446(b); Giddio v. Commissioner, 54 T.C. 1530 (1970).

In many respects, the record in this case represents a failure of proof by petitioners. The amount of James' gross receipts from the precious metals business was established by stipulation of the parties, and, at trial, respondent conceded and stipulated that James had advertising expenses in connection with the precious metals operation in the amount of $9,473. Beyond this, however, nothing was agreed, and the burden was on petitioners to prove the cost of goods sold and any related and allowable deductions with respect to the precious metals operation.

With the exception of two items, petitioners have failed in their necessary burden of proof. Petitioners testified as to the costs of maintaining a display room in a hotel in Cumberland for the purpose of purchasing coins and gold and silver, as well as the cost of a "store front" in Hagerstown, maintained later in the period for the same purpose. Although they testified as to the costs of these rentals, such testimony was completely unsupported by any corroborative evidence. Likewise, one or both petitioners testified as to advertising costs in radio spot commercials, but neither one was able to come up with a dollar amount of such costs or any other record to support the claim. Likewise, although petitioners testified in a general way as to the cost of supplies, equipment and the like (some of which may have been capital expenditures) which were necessary for the conduct of the precious metals operation, neither their testimony nor any corroborative evidence was offered to give us an idea of the amount of such expenses. While we are satisfied that James incurred some expense in display space rentals both in Cumberland and Hagerstown, and may well have incurred advertising expense on the radio, we cannot pick a figure out of thin air; we must have some basis to go on. Nor can respondent be faulted for failing to make allowance for any such deductible items, in the absence of any evidence to support them. If respondent's adjustments are inaccurate because the taxpayer had no books or failed to produce them, the taxpayer must suffer the consequences. Figueiredo v. Commissioner, 54 T.C. 1508 (1970), affd. by unpublished order (9th Cir. 1973); Estate of Mason v. Commissioner, 64 T.C. 651 (1975), affd. 566 F.2d 2 (6th Cir. 1977).

On the other hand, where the taxpayer carries his burden of proof to show that certain expenses were in fact incurred, although the record may be less than clear as to the exact amount thereof, we can, in our discretion, make such allowances as are reasonable under the circumstances. As the Court of Appeals said in Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930), affg. and remanding 11 B.T.A. 743 (1928):

> Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. * * *

The record herein does give us some basis for making findings herein with regard to James' cost of goods sold and his automobile expense.

There was stipulated and admitted into evidence a record of purchases made by James during the course of the precious metals operation.[3] The testimony of both petitioners was that this purchase record was not an original document, but was copied by Diane from the original, which had become mildewed and watersoaked so as to be difficult to read, and was thereafter destroyed. Respondent complains of this on brief, as not being a credible or contemporaneous document, but we are satisfied from petitioners' testimony that the original was not lost or destroyed due to petitioners' bad faith, and that it is no longer available. We are further satisfied that the document in evidence is an accurate copy of the original document, and therefore was properly admissible in evidence. Rule 1004, Fed. R. Evid.

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[3] Although stipulated into evidence as a joint exhibit, respondent made clear to the Court at trial, and the Court accepted, that respondent was stipulating only to the document as petitioners' exhibit, and was not agreeing to the truth of the contents thereof.

The document itself is less than perfect. Although it gives itemized descriptions and costs for each item purchased, and although we can assume that the record was keep chronologically, no dates are given by which we can determine those purchases which were made in the months of August through December 1980, as opposed to those made in January of 1981, a year which is not before us. Since the total span of time involved is six months, however, and since only one month of those six was outside the year 1980, we will apply our discretion under Cohan by allocating the purchases equally over the six months. This means that only five-sixths of the total amount of purchases, constituting James' cost of goods sold, or $116,849.66, should be credited as costs of goods sold in 1980.

As to automobile expenses, the parties stipulated the mileage between Hagerstown and Cumberland on the one hand, and Hagerstown and Gaithersburg on the other hand. Using the record of advertisements placed in the Cumberland newspaper as a basis for the times when James would go to Cumberland to purchase precious metals (the dates of the newspaper advertisements were introduced into evidence) we have determined that 26 such roundtrips were made by automobile, which under the optional method of computing automobile travel expense of $.20 per mile, as in effect in 1980, see section 162 and Rev. Proc. 80-32, 1980-2 C.B. 767, produces an automobile travel cost of $707.20. We consider that such cost is not allowable as a deduction herein, however, since it constitutes nondeductible commuting expense between James' home in Hagerstown and his place of business in Cumberland. Sections 1.162-2(e) and 1.262-1(a)(5), Income Tax Regs. On the other hand, the trips from Hagerstown to Gaithersburg to sell the precious metals cannot be considered a commuting expense and should be allowable. Based upon the dates of the checks issued by the Gaithersburg Coin Exchange, Inc. in payment for precious metals when they were brought in, we have determined that 20 such roundtrips were made, and the parties have stipulated that the distance was 49 miles each way. Using the same $.20 per mile allowance, as above, we feel that petitioners are entitled to a deduction of $392 for such travel expense.

Based upon the stipulated amount of James' gross receipts, and the allowable expense, as we have found it to be herein, the results are as follows:

Gross Receipts	$124,906.00	
Less: Cost of goods Sold	116,849.66	
Gross Income		$ 8,056.34
Less Allowable Expenses:		
Advertising expense	$ 9,473.00	
Auto expense	392.00	9,865.00
Net Income (Loss)		($1,808.66)

It thus results that, even allowing petitioners the few offsets for which there is some basis in this record, under the standards of Cohan, the final outcome is still that James had a net loss in his precious metals operation for 1980 and, given the type of deductions which we have allowed, this would be true whether James is considered to have been engaged in a trade or business or not.[4] Sections 161, 162, 183(b)(2).

There can be no question that petitioners should have reported their gross receipts, their gross income and their allowable deductions from the precious metals operations in their 1980 return. Their failure to do so was improper but, as we have found, the net result is still that there was no unreported taxable income from this source for 1980. So far as respondent is concerned, therefore, it is a case of damnum absque injuria.

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[4] Petitioners did not claim a net operating loss from the precious metals operation for 1980.

Since there was no unreported taxable income, there can be no deficiency of tax; and without an underpayment of tax, no additions to tax under section 6653(b) are applicable.

Decision will be

entered for petitioners.

742-B Ju 11.7/2:1986-26

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T. C. Memo. 1986-26

UNITED STATES TAX COURT

ROSE SANDERS, Petitioner v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 27352-83. Filed January 22, 1986.

Joyce Rebhun, for the petitioner.

Howard Rosenblatt, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined deficiencies and additions to tax as follows:

		Additions to Tax	
Year	Deficiency	Sec. 6653(a)[1]	Sec. 6654(a)
1980	$3,283.57	$ 27.43	-
1981	4,933.00	246.65	$472.07

The deficiencies resulted from respondent's determination that petitioner had failed to report community income attributable to her husband, a tax protester who failed to file returns for the years in issue. Petitioner contends that she and her then husband had agreed that such earnings would be separate property.

FINDINGS OF FACT

Petitioner was a resident of Phoenix, Arizona, at the time she filed her petition herein. She timely filed individual income tax returns for 1980 and 1981, reporting her earnings and indicating a filing status of married filing separate return.

During 1980 and 1981, petitioner was married to Darrel Sanders (Sanders), and she and Sanders resided in Arizona. Petitioner earned $15,445 in 1980 and $15,245 in 1981. Sanders earned $32,256 during 1980 and $39,514 in 1981. Neither petitioner nor Sanders reported his earnings on any tax return.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

During the years in issue, petitioner and Sanders maintained a joint bank account into which they deposited some or all of their earnings and out of which they paid community expenses and obligations owed by Sanders to his former wife. Sanders did not otherwise advise petitioner of the amount of his earnings during the years in issue. Petitioner knew that Sanders was employed and that he was not filing tax returns, but petitioner did not know the amount of Sanders' earnings.

At the time she filed her tax returns for 1980 and 1981, petitioner sought advice from her preparer, from the Internal Revenue Service, and from the State of Arizona as to the proper means of filing her tax return. She was advised to write a note on her tax return disclosing the situation. On her Federal income tax return for 1981, petitioner included a note as follows:

> t/p unable to report Community Property Income. t/p is reporting only her income and related expenses -- t/p has no knowledge of Husband's income -- S.S etc.
>
> 3-5-82 [signed] Rosemary Sanders

Respondent determined that one-half of petitioner's earnings reported on her returns was attributable to Sanders and that one-half of Sanders' earnings was attributable to petitioner during the years in issue.

OPINION

This case illustrates the unfortunate and unintended consequences of the folly of tax protest. Although petitioner attempted to comply with her tax obligations, her marriage to a protester and their residence in a community property state have subjected her to the consequences of his noncompliance. Because no joint returns were filed for the years in issue, petitioner is denied the potential benefits of joint return rates. See sections 1(a) and (d). At the same time, because petitioner knew of Sanders' receipt of income from his employment, she does not qualify for relief as an "innocent spouse." Section 66(c)(3).

The principles applicable to this case were stated in Beall v. Commissioner, 82 T.C. 70, 71-73 (1984), as follows:

> Arizona law provides that the earnings of either spouse are community property, and each spouse has an equal one-half interest in those earnings. Ariz. Rev. Stat. Ann. sec. 25-211 (West 1976); Goodell v. Koch, 282 U.S. 118 (1930). A married person is taxable on the earnings of his or her spouse to the extent that he or she has a vested ownership interest in the spouse's earnings. United States v. Mitchell, 403 U.S. 190, 196-197 (1971); Edwards v. Commissioner, 680 F.2d 1268 (9th Cir. 1982), affg. an unreported decision of this Court.
>
> Arizona law permits spouses to enter into an agreement whereby subsequent earnings of either spouse will remain the separate property of the spouse earning the income, and such agreement, if valid under Arizona law, will be recognized for tax purposes. Shoenhair v. Commissioner, 45 B.T.A. 576 (1941); Naegle v. Commissioner, T.C. Memo. 1965-212, affd. on another issue 378 F.2d 397 (9th Cir. 1967). The burden of proving such a valid agreement, however, is on petitioner. Rule 142(a), Tax Court Rules of Practice and Procedure.

> * * *
>
> The law requiring petitioner to report as income her share of her husband's earnings is well established and applied even where the result seems inequitable. See United States v. Mitchell, supra; Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980); Bagur v. Commissioner, 603 F.2d 491 (5th Cir. 1979). * * *

Petitioner contends that the arrangements between her and Sanders during the years in issue constituted an agreement to transmute their earnings into separate property. This contention, however, is inconsistent with the contemporaneous statement contained on petitioner's 1981 tax return. Her prior good faith efforts to report his income as community income on her returns unfortunately undermine her present contention that they had agreed prior to their marriage that such income was not community property. In any event, her present argument is not supported by the evidence.

Petitioner and Sanders testified that each of them contributed $800 per month to the joint bank account, which was used to pay community expenses and separate obligations of Sanders.[2] Both had been married before and approached the second marriage with caution. Each testified that Sanders did not pay income taxes and that he refused to provide information to petitioner with respect to his earnings. Neither, however, provided any specifics of an alleged premarital agreement that the earnings would be separate property. It appears that such alleged agreement is an afterthought for purposes of this case.

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[2] It is ironic that her earnings, which were less than half of his, contributed more toward support of the community. Under these circumstances, it is doubtful that a Court would determine that his earnings were separate property to which she had no claim.

Petitioner has failed to carry her burden of proving that the earnings were not community property. See *Beall v. Commissioner*, *supra*; *Kroloff v. United States*, 487 F.2d 334, 336 (9th Cir. 1973); *Barr v. Petzhold*, 77 Ariz. 399, 273 P.2d 161 (1954); *Porter v. Porter*, 67 Ariz. 273, 279, 195 P.2d 132, 136 (1948).

Petitioner made a bona fide attempt to comply with her obligation to report her share of her husband's earnings. Under the circumstances of this case we conclude that her failure to report her share of those earnings was not due to negligence or intentional disregard of rules and regulations. The additions to tax under section 6653(a) are not sustained.

The addition to tax under section 6654(a) for failure to pay estimated tax, however, is mandatory absent exceptions not here applicable. *Grosshandler v. Commissioner*, 75 T.C. 1, 21 (1980).

Decision will be entered for the respondent for the amounts of the deficiencies and addition to tax under section 6654(a) only.

142-B

Ju 11.7/2: 1986-27

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T. C. Memo. 1986-27

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UNITED STATES TAX COURT

ESTATE OF CLARENCE McDOWELL, DECEASED, PEGGY NYSTROM,
PERSONAL REPRESENTATIVE, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27520-83.   Filed January 22, 1986.

David N. Niklas, for the petitioner.

Joel Lopata, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, *Judge*: Respondent determined a deficiency of $21,098.21 in petitioner's Federal estate taxes. After concessions, the issues for decision are (1) whether an annuity obligation, in excess of payments actually made, represented a claim against the estate deductible under

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section 2053(a)(3);[1] and (2) if the claim is deductible, whether the amount deductible should be determined actuarially.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and accompanying exhibits are incorporated herein by this reference.

Petitioner is the Estate of Clarence McDowell ("the decedent") who died testate on February 26, 1980. The decedent was domiciled near Chester, Montana, at the time of his death, and his estate was probated in the Twelfth Judicial District of the State of Montana in and for the County of Liberty. Peggy Nystrom ("Peggy"), the decedent's daughter, was nominated and qualified as the decedent's personal representative under his will. The sole beneficiaries under the will were Peggy and her brother Lance McDowell ("Lance"). Petitioner was solvent.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect for the tax in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner argues that the issue of deductibility was not timely raised. An issue is properly raised if the opposing party is given fair notice of the matter in controversy. Markwardt v. Commissioner, 64 T.C. 989, 997 (1975). Fair notice requires that the opposing party not be harmed or prejudiced in his ability to prepare for trial. Schuster's Express, Inc. v. Commissioner, 66 T.C. 588, 593-594 (1976), affd. without published opinion 562 F.2d 39 (2d Cir. 1977). Here, petitioner has not demonstrated that it was harmed or prejudiced in its ability to prepare for trial. In addition, we believe that the language of the notice of deficiency was broad enough to raise both the issue of proper valuation and the issue of deductibility.

The decedent was a rancher who spent most of his life on a family ranch 31 miles north of Chester, Montana. Both Peggy and Lance were raised at the ranch, and Lance continued to reside and work at the ranch as an adult. Alister Murray ("Alister") lived two or three miles from the decedent and his family and had a close relationship with them. Alister was single and had no relatives in the United States. He led a quiet life with few social contacts.

Prior to 1976, Alister owned a ranch and was engaged in ranching operations. In 1976 Alister was injured as a result of an accident and decided to retire from ranching. Eventually, Alister entered into an annuity agreement with the decedent and Lance which provided for the sale of his ranch and other property to the decedent and Lance in consideration for their promise "to pay * * * his expenses for an agreeable room monthly at the Liberty County Nursing Home, Chester, Montana, during [Alister's] lifetime" or if Alister did not reside at the Liberty County Nursing Home to "pay directly to [Alister] each month a sum equal to the expenses for such an agreeable room at the Liberty County Nursing Home." Such payments were to be made monthly. In addition, the decedent and Lance promised to pay other stipulated expenses up to $100.00 per month. The agreement also provided that the decedent and Lance would provide Alister accommodations at the decedent's ranch at Alister's request. The decedent and Lance were jointly and severally liable on the contract. The decedent had a 50 percent interest in the contract, and 50 percent of the value of the property received was included in the decedent's estate.

Alister did move to Liberty County Nursing Home and resided there until his death on June 27, 1980, at the age of 74. Initially, Alister resided in a minimal care facility which was affiliated with the nursing home. However, by 1979 his health had deteriorated, and he was moved to the nursing home on May 25, 1979.

In May of 1979 Dr. Richard S. Buker, Alister's attending physician, became concerned about the deterioration of Alister's health. Dr. Buker suspected that Alister had an artery block, which resulted in a series of small strokes. This condition could have been corrected by surgery. In order to confirm this diagnosis, Dr. Buker had Alister examined at Great Falls Hospital which had more sophisticated diagnostic facilities than those available at Liberty County Hospital. The consultants at Great Falls Hospital recommended against surgery because of the magnitude of other medical problems they identified which they felt would result in Alister's death within a year.

Dr. Buker did not agree with the prognosis or diagnosis made by the consultants at Great Falls Hospital. The autopsy performed by Dr. Buker showed that their diagnosis was incorrect.

In the period succeeding his examination at Great Falls Hospital, Alister experienced significant and severe deterioration in his health. Although he did not accept the diagnosis or prognosis made by the consultants at Great Falls Hospital, Dr. Buker felt that Alister had a life-threatening problem and that his outlook for the future was poor. As confirmed by the autopsy, Alister's primary problem was the artery block. This condition could have been corrected by surgery up to the week in which Alister died. Without the corrective surgery, Alister continued to experience strokes which resulted in various physical problems which he had during the last year of his life. As a result of these problems, Alister died of asphyxiation which is the usual cause of death for individuals with this condition.

The decedent predeceased Alister by approximately four months. The decedent's will provided, in part:

> VI.
>
> I have previously hereto purchased the Alister Murray Ranch with my son, Lance Ray McDowell. * * * I further direct that my devisees herein continue my obligations to Alister Murray until the death of Alister Murray. [Emphasis added.]

Lance had visited Alister on the day of the decedent's funeral and had promised to continue the annuity agreement. Lance acted as agent to the personal representative during the probate proceedings, and Peggy, the personal representative, concurred in his statement to Alister. Petitioner did, in fact, continue to make payments until Alister's death. The total payments made by petitioner during the period between the decedent's death and Alister's death were in the amount of $2,560.25.

Peggy published a notice to creditors approximately three to four weeks after the decedent's death. No claim was ever presented by or on behalf of Alister pursuant to Mont. Code Ann., Title 72, ch. 3, part 8 (1974, as amended). However, Peggy believed that the oral commitment made by Lance was sufficient to waive any defenses of limitations which would bar payment of the claim.

Peggy filed a Federal estate tax return for petitioner on December 1, 1980. On the Federal estate tax return, the amount of the deduction reported for the annuity obligation to Alister was $37,184.04. The amount was computed by applying the annuity figure from section 20.2031-10(f), Table A(1), Estate Tax Regs., and the adjustment for monthly payments from section 20.2031-10(b)(2), Estate Tax Regs., to the average monthly amount paid pursuant to the annuity agreement in 1980. One-half of this amount was reported as the decedent's obligation.

OPINION

Petitioner asserts that the amount of $37,184.04, the full actuarial value of one-half of the annuity obligation, is deductible from the value of the gross estate as a claim against the estate under section 2053(a)(3). Respondent maintains that the annuity obligation was not enforceable against the estate except to the extent of payments made in the amount of $2,560.25 and is therefore not deductible under section 2053(a)(3). In the alternative, respondent contends that the annuity obligation should not be valued by the use of the actuarial tables provided in section 20.2031-10(f), Estate Tax Regs. At issue is whether events occuring subsequent to the decedent's death resulted in the annuity obligation becoming unenforceable for Federal estate tax purposes and whether Alister's death was imminent at the date of the decedent's death.

Enforceability of the Annuity Obligation

Section 2053(a)(3) provides a deduction from the gross estate for "claims against the estate * * * as are allowable by the laws of the jurisdiction * * * under which the estate is being administered." The legislative history of the statute and its predecessors does not state when the time a claim should be allowable, or allowed under the predecessor statutes, is determined. Section 20.2053-4, Estate Tax Regs., further provides that only those claims "enforceable" against the decedent's estate may be deducted. The regulation does not state when enforceability must be determined.

This Court and others have attempted to formulate a rule pertaining to the effect of post-death events on the allowance or enforceability of a claim against the estate. See, e.g., Commissioner v. Shively's Estate, 276 F.2d 372 (2d Cir. 1960); Commissioner v. Strauss, 77 F.2d 401 (7th Cir. 1935); Jacobs v. Commissioner, 34 F.2d 233 (8th Cir. 1929); Estate of Van Horne v. Commissioner, 78 T.C. 728 (1982), affd. 720 F.2d 1114 (9th Cir. 1983); Estate of Courtney v. Commissioner, 62 T.C. 317 (1974); Estate of Hagmann v. Commissioner, 60 T.C. 465 (1973), affd. 492 F.2d 796 (5th Cir. 1974); Russell v. United States, 260 F. Supp. 493 (N.D. Ill. 1966); Winer v. United States, 153 F. Supp. 941 (S.D. N.Y. 1957).[2] In a recent case we explained the significance of post-death events when considering the enforceablity of a claim. *Estate of Van Horne v. Commissioner*, *supra* at 733-734. After analyzing the prior cases in this area, we concluded that "all of the cases in this field dealing with post-death evidence are not easily reconciled with one another, and at times it is like picking one's way through a minefield in seeking to find a completely consistent course of decision in this area." *Estate of Van Horne v. Commissioner*, *supra* at 736-737. In *Estate of Van Horne v. Commissioner*, we explained the seemingly inconsistent positions in our prior cases stating that post-death events should be considered where the claim is "potential, unmatured, contingent, or contested" at the date of death and an examination of subsequent events is necessary to determine whether the claim "actually ripened" into an enforceable claim. *Estate of Van Horne v. Commissioner*, *supra* at 733-735. An obligation which becomes void under state law if no claim is filed within a prescribed statutory period was characterized as a potential claim under this analysis. *Estate of Van Horne v. Commissioner*, *supra* at 736.

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[2] The effect of post-death events on the allowance or enforceability of a claim has also been the subject of debate among commentators. See, e.g., Zimmerman, Claims Against the Estate: A Continuing Controversy, 10 Est., Gifts & Tr. J. 65 (1985); Note, Current Problems Facing the Executor Taking the Section 2053 Estate Tax Deduction, 30 Vand. L. Rev. 795 (1977); Palmquist, The Estate Tax Deductibility of Unenforced Claims Against a Decedent's Estate, 11 Gonz. L. Rev. 707 (1976); Note, Estate and Income Tax: Claims Against the Estate and Events Subsequent to Date of Death, 22 UCLA L. Rev. 654 (1975); Note,
(footnote continued)

Some courts have viewed the test of allowance or enforceability as applying at the date of death and permitted a deduction for an obligation which subsequently becomes

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(footnote continued from previous page)
Effect of Events Subsequent to the Decedent's Death on the Valuation of Claims Against His Estate Under Section 2053 of the Federal Estate Tax, 1972 U. Ill. L.F. 770 (1972).

unenforceable when the creditor fails to file a claim as required by state law. Commissioner v. Strauss, supra; Russell v. United States, supra; Winer v. United States, supra. In both Strauss and Winer obligations existed at the date of the decedent's death but no claims were presented pursuant to state law nor were the obligations paid. However, the courts in both cases permitted a deduction from the gross estate for the amount of the obligations under the predecessor of section 2053(a)(3). The court in Winer explained that the claim should be allowed irrespective of presentation "[s]ince plaintiff possessed an enforceable claim at the time of the decedent's death." Winer v. United States, supra at 944. The Court of Appeals for the Ninth Circuit to which this case is appealable has cited Strauss and Winer with approval. Propstra v. United States, 680 F.2d 1248, 1254 (9th Cir. 1982). The Court of Appeals for the Ninth Circuit has applied the rule in Propstra to actuarially determined legally enforceable claims. Estate of Van Horne v. Commissioner, 720 F.2d 1114, 1117 (9th Cir. 1983).

Here, petitioner concedes that no claim was presented by or on behalf of Alister pursuant to applicable state law. However, petitioner argues that Alister's failure to file a claim did not render the obligation unenforceable because Peggy and Lance waived the requirement of presentation of the claim and the decedent's testamentary direction to his devisees required that the personal representative discharge the obligation irrespective of presentation of a claim. In the alternative petitioner argues that presentation of a claim would be a futile act and that the Federal estate tax law does not require such a futile act.[3]

Petitioner's first argument requires an examination of the statutory provisions related to creditors' claims against an estate under Mont. Code Ann., Title 72, ch. 3, part 8 (1979). As applicable to this case, the statutory scheme requires that, upon appointment, the personal representative shall publish notice to the creditors once a week for three successive weeks. Mont. Code Ann sec. 72-3-801 (1979). If proper notice is given, all claims against the estate must be presented within four months after the date of first publication of notice. Mont. Code Ann. sec. 72-3-803(1)(a) (1979). Any claim not presented within the four-month period "if not barred earlier by other statute of limitations [is] barred against the estate, the personal representative, and the heirs and devisees of the decedent." Mont. Code Ann. sec. 72-3-803(1)(1979). The manner in which claims must be presented is prescribed by Mont. Code Ann. section 72-3-804 (1979). If the personal representative disallows a claim which is timely presented in accordance with Mont. Code Ann. sections 803 and 804 (1979) the claimant may commence a proceeding against the personal representative. Mont. Code Ann.

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[3] Petitioner has not argued nor have we considered whether Lance's statements would have estopped the personal representative from denying presentation or whether they constituted a compromise under Mont. Code Ann. sec. 72-3-815 (1979).

sec. 72-3-805 (1979). Presentation is not a requisite to payment of a claim, and the personal representative may pay any just claim which has not been barred with or without formal presentation. Mont. Code Ann. sec. 72-3-808(3) (1979).

There is an exception to the statutory bar of Mont. Code Ann. section 72-3-803(1) (1979). Under the statutes the personal representative of a solvent estate, with the consent of all successors, may waive any defense of limitations available to the estate. Mont. Code Ann. sec. 72-3-802 (1979). Successors are defined as "those persons, other than creditors, who are entitled to the property of a decedent under his will or this code." Mont. Code Ann. sec. 72-1-103(42) (1979). The statute does not require any specific form of waiver. In this case Lance visited Alister after the decedent's death and promised that the annuity agreement would be continued.[4] Lance acted as the agent to the personal representative, and she concurred in his promise. The only beneficiaries under the decedent's will were Lance and Peggy who also was appointed as the personal representative. Consequently, all parties required to agree to a waiver of the period of limitations for presentment of a claim had, in effect, consented to an extension of the period for presentment under Mont. Code Ann. section 72-3-803(1) (1979). The estate was solvent, and the parties had the authority to consent to such a waiver. Although it is unlikely that most creditors would rely on an oral waiver, the record clearly indicates that the decedent, Peggy, and Lance had a close personal relationship with Alister. Under these circumstances, we believe that Lance's statements and Peggy's acquiescence were intended to waive the period for presentment of a claim and that they were in fact sufficient to waive the period for presentment under Mont. Code Ann. sec. 72-3-803(1) (1979). The fact that petitioner did continue to make payments pursuant to the annuity obligation supports this conclusion.

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[4] Lance visited Alister after the decedent's death and Alister was able to discuss the annuity obligation and the decedent's death. While Dr. Buker, Alister's physician, suggested that Alister would have been unable to participate in a conversation of the nature described by Lance, we found Lance to be a highly credible witness and believe that any discrepancy between the testimony of Lance and Dr. Buker can be explained by the fact that Alister was one of a number of elderly patients treated by Dr. Buker, suggesting that Dr. Buker's recollection of Alister's condition at any given date might not be completely accurate. We note that the nursing home records introduced into evidence do not conclusively indicate that Alister's mental condition had deteriorated to the extent that he could not conduct a conversation of the nature described by Lance.

Although we have determined that Lance's and Peggy's actions were sufficient to waive the statutory period for presentment of a claim under Mont. Code Ann. section 72-3- 803(1) (1979), we cannot agree with petitioner's argument that the requirement of presentment was also waived. The effect of waiver of the period for presentment of Alister's claim would permit the personal representative to continue to make annuity payments after the normal period for presentment of claims prescribed by Mont. Code Ann. section 72-3-803(1) (1979). Mont. Code Ann. sec. 72-3-

808(3) (1979). However, the personal representative's decision to make such payments would clearly be discretionary, and Alister would have had to present a claim and commence a proceeding pursuant to Mont. Code Ann. section 72-3-805 (1979) in order to compel payment. When Alister died there was no further opportunity to file a claim for any amounts other than those actually expended up to the time of his death.

Petitioner's second argument relates to the direction in the decedent's will that his devisees shall "continue my obligations to Alister Murray until the death of Alister Murray." Petitioner maintains that this direction required the personal representative to discharge the obligation to Alister without presentment of a claim. Some jurisdictions do recognize an exception to the requirement of presentation of a claim by a creditor where there is a specific direction in the decedent's will as to the payment of the decedent's debts. Annot., 65 A.L.R. 861 (1930). These cases involve a direction to the executor or personal representative where the payment of the claim is to be made during the course of the estate administration. We have found no case which permits an exception to the requirement of presentation where the direction was made to the devisees and not the executor or personal representative. As the payment of the claim would be made within the course of administration of the estate where the direction is to the executor or personal representative, just as it would be if the creditor presented a claim, the rule permitting enforcement of such an obligation without presentation of a claim does not unduly affect the underlying policy of the Montana Uniform Probate Code to "promote a speedy and efficient system for liquidating the estate of the decedent and making distribution to its successors." Mont. Code Ann. sec. 72-1-102(2)(c) (1979). However, the situation is different where the direction is to the devisees. There the payment of the obligation, without presentation of a claim, would be made outside the administration of the estate, and in the absence of a clear judicial or statutory mandate, we do not believe that permitting such a claim to be enforceable without presentation promotes the underlying policies of the Montana Uniform Probate Code.

Petitioner's final argument is that filing a claim would have been futile in this case and that the Federal estate tax laws do not require such a futile act. In support of this proposition, petitioner cites Rev. Rul. 60-247, 1960-2 C.B. 272. The revenue ruling adopted the analysis of Estate of Feder v. Commissioner, 22 T.C. 30 (1954), where the creditor was also the sole beneficiary of the estate and would receive an amount from the estate at least equal to the amount of the obligation. In such an instance, the revenue ruling acknowledged that formal presentation and payment of the claim would be a futile act. Neither the revenue ruling nor Estate of Feder suggested that this exception should be extended beyond the specific factual situation involved in the case, and we can discern no reason to adopt a general exception which would apply where the death of an annuitant terminates the right to further payments.

The Court of Appeals for the Ninth Circuit to which appeal would lie in this case has stated that the analysis of Commissioner v. Strauss, supra, and Winer v. United States, supra, is persuasive as to the relevance of post-death events with regard to claims that are certain and enforceable at the time of death. Propstra v. United States, supra at 1254. Both Strauss and Winer permit the allowance of deductions for obligations which are enforceable at the decedent's date of death but are subsequently rendered unenforceable as a result of the creditor's failure to file a claim. Respondent does not dispute and the record clearly shows that the annuity obligation in this case was a valid, enforceable obligation at the date of the decedent's death. Nothing more is required for a deduction under section 2053(a)(3) pursuant to the position adopted by the Court of Appeals for the Ninth Circuit, which stated:

> We rule that as a matter of law, when claims are for sums certain and are legally enforceable as of the date of death, post-death events are not relevant in computing the permissible deduction. [Propstra v. United States, supra at 1254; Estate of Van Horne v. Commissioner, supra at 1116.]

Consequently, we conclude in these circumstances that the value of the annuity obligation, in excess of the payments actually made, was a deductible claim under section 2053(a)(3).

Valuation of the Annuity Obligation

Respondent has provided tables for the valuation of annuity obligations in section 20.2031-10(f), Estate Tax Regs. Courts will permit substitution of actual life expectancy for actuarial life expectancy only in exceptional circumstances. Bank of California v. United States, 672 F.2d 758, 759-760 (9th Cir. 1982); Continental Ill. Nat. B. & T. of Chicago v. United States, 504 F.2d 586, 593 (7th Cir. 1974). The party contending that the actuarial tables are inapplicable bears the burden of proof. Bank of California v. United States, supra at 759.

Here, petitioner used the annuity tables in valuing the obligation for purposes of section 2053(a)(3). Respondent maintains that the use of the annuity tables in this instance was erroneous because Alister's death was imminent at the date of the decedent's death. Respondent does not argue that petitioner's computation pursuant to these tables is in error. As respondent seeks to deviate from the use of the annuity tables, he has the burden of proof on this issue. For the reasons discussed below, respondent has not met his burden of proof.

Dr. Buker, Alister's attending physician, testified as to Alister's physical condition during the year preceding his death on June 27, 1980. Dr. Buker testified that as early as May of 1979 he felt that Alister's death was imminent. However, Dr. Buker explained that it was possible that Alister could have lived as long as two and perhaps as long as three years beyond the date of the decedent's death on February 26, 1980.

Alister's primary medical problem was an artery block which could have been corrected by surgery up to the week in which he died. Dr. Buker did not explain why the surgery was not performed. Although specialists at the Great Falls Hospital where Dr. Buker had Alister examined in May of 1979 had recommended that the surgery not be performed as they believed that Alister's life expectancy was less than one year, Dr. Buker did not concur in their diagnosis or prognosis. In fact the autopsy performed by Dr. Buker showed that the diagnosis was incorrect.

Respondent submitted no evidence other than the fact of Alister's death approximately four months subsequent to the decedent's death and Dr. Buker's testimony to support his contention that Alister's death was imminent at the date of the decedent's death. While Dr. Buker's testimony clearly shows that Alister was in poor physical condition at the time of the decedent's death, his testimony also indicates that Alister's condition was treatable. The fact that Alister's condition was not treated does not justify a deviation from the annuity tables. Consequently, we find that petitioner properly used the annuity tables to compute the amount of the deduction for the annuity payable to Alister.

To reflect the foregoing,

Decision will be entered

under Rule 155.

COMPLETED
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742-B

Ju 11.7/2:1986-28

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T. C. Memo. 1986-28

UNITED STATES TAX COURT

TONY GRUBAUGH, Petitioner v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket No. 1707-85. Filed January 22, 1986.

P attempts to place tax years 1979-1984 at dispute in this Court. Tax years 1979 and 1980 were closed out by Order of Dismissal and Decision entered on August 24, 1983 from which no appeal was taken. No notice of deficiency was issued to P for tax years 1982-1984. Sec. 6212, I.R.C. 1954. Petition for tax year 1981 not timely filed. Secs. 6213 and 7502, I.R.C. 1954. Held, R's Motion to Dismiss for Lack of Jurisdiction is granted.

Tony Grubaugh, pro se.

Jeffrey A. Hatfield and Will E. McLeod, for the respondent.

MEMORANDUM OPINION

DRENNEN, *Judge*: Petitioner's Motion - To Dismiss With Prejudice - By Defendant - Harrassment, respondent's Motion to Dismiss for Lack of Jurisdiction and petitioner's Motion to Dismiss Failure by Respondent to Answer Motion to Dismiss in Thirty Days were assigned to Special Trial Judge Francis J.

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Cantrel for consideration and ruling thereon. After a review of the record, we agree with and adopt his opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

CANTREL, Special Trial Judge: This case is before the Court on the following motions:

(1) Petitioner's Motion - To Dismiss With Prejudice - By Defendant - Harrassment filed on September 30, 1985;

(2) Petitioner's Motion to Dismiss Failure by Respondent to Answer Motion to Dismiss in Thirty Days filed on November 29, 1985; and

(3) Respondent's Motion to Dismiss for Lack of Jurisdiction filed on December 2, 1985.[1]

Despite the indiscriminate filing of non-meritorious papers in this proceeding by petitioner we have, at a considerable waste of precious judicial time, given this record careful consideration. Since we conclude that we lack jurisdiction we have no authority to entertain petitioner's motions.

On January 22, 1985 the petition herein was filed which had attached thereto some 33 pages, most of which contain wholly irrelevant materials. As we view the petition as a whole, it appears to be attempting to place the taxable years 1979 through 1984 before this Court.

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[1] This case was assigned pursuant to sec. 7456(d)(4), Internal Revenue Code of 1954, as amended, and Delegation Order No. 8, 81 T.C. XXV (1983).

Petitioner is no stranger to this Court. He has been here before in the case designated docket number 19843-82. There, on May 4, 1982, respondent issued a notice of deficiency to petitioner wherein he determined Federal income tax deficiencies and additions to the tax to be due from petitioner for the taxable years 1979 and 1980. A timely mailed and, thus, timely filed petition was filed in that case.[2] See section 7502.[3] The case was called for trial at Los Angeles, California on July 11, 1983 and recalled on July 14, 1983. Petitioner exhorted that he was entitled to deductions that were not allowed by respondent. He promised to provide respondent with information respecting those deductions. This Court granted petitioner additional time to provide the information but petitioner was clearly and emphatically admonished that if he did not do so the case would be dismissed for failure properly to prosecute. When petitioner did nothing the Court entered an Order of Dismissal and Decision on August 24, 1983.[4] No appeal was taken from that decision and it has become final for all purposes. See sections 7481(a)(1) and 7483.

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[2] We note that the address therein that petitioner was using for mailing purposes was that of the tax service he employs. In our opinion, based on this record and that pertaining to the case designated docket number 19843-82, it appears that petitioner may be relying on misinformed tax advice.

[3] All section references are to the Internal Revenue Code of 1954, as amended.

[4] Indeed, petitioner attached a portion of that Order of Dismissal and Decision to the petition he filed herein.

In his motion respondent contends that petitioner has not shown that a notice of deficiency was issued to him for the taxable years 1982 through 1984.[5] At the hearing at Washington, D.C. on December 4, 1985 respondent argued that (based on his records) no notice of deficiency was issued to petitioner for those years.

Generally, Tax Court jurisdiction exists only if there has been issued a valid statutory notice of deficiency and a timely petition filed therefrom. Sections 6212 and 6213; Rules 13 and 20.[6] A valid petition may not be filed in the Tax Court without the issuance of a valid statutory notice of deficiency, sometimes referred to as a "ticket to the Tax Court." Midland Mortgage Co. v. Commissioner, 73 T.C. 902 (1980); Baron v. Commissioner, 71 T.C. 1028, 1034 (1979); Jones v. Commissioner, 62 T.C. 1, 2 (1974); Corbett v. Frank, 293 F.2d 501 (9th Cir. 1961).[7] Petitioner, in his reply to respondent's answer filed on May 13, 1985, affirmatively alleges, in part, as follows--" * * * All other years [i.e., all years other than 1981], as admitted by the I.R.S. in their (sic) answer are not at issue, with which I agree." Thus, it is crystal clear that no notice of deficiency was issued to petitioner for the taxable years 1982 through 1984 and we so find.

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[5] Respondent served a copy of his motion with attachments on petitioner on November 26, 1985.

[6] All Rule references are to the Tax Court Rules of Practice and Procedure.

[7] We observe that venue on appeal of this case lies in the United States Court of Appeals for the Ninth Circuit.

This brings us to the taxable year 1981. Section 6212 provides that if the Secretary determines that there is a deficiency in respect to any tax he is authorized to send notice of such deficiency to the taxpayer by certified or registered mail. Notice of a deficiency in respect of a tax, if mailed to a taxpayer at his last known address, shall be sufficient.

The record is clear that respondent by certified mail (402843) on September 1, 1983 issued a notice of deficiency to petitioner at his last known address pursuant to section 6212. Therein, respondent determined a deficiency in petitioner's Federal income tax and additions to the tax for the taxable calendar year 1981 in the following respective amounts:

		Additions to Tax, I.R.C. 1954			
Yr.	Income Tax	Sec.6651(a)	Sec.6653(a)(1)	Sec.6653(a)(2)	Sec.6654
1981	$6,484.00	$1,621.00	$324.20	50% of the interest due on $6,484.00	$497.19

Section 6213(a), which permits the filing of petitions with this Court, provides in pertinent part--

> Within 90 days * * * after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. * * *

The 90th day after the mailing of the notice of deficiency was Wednesday, November 30, 1983, which was not a legal holiday in the District of Columbia. The petition was filed on January 22, 1985 and the envelope in which the petition was received by the Court bears a clearly legible U.S. Postal Service postmeter stamp date of January 18, 1985, both of which dates are far beyond the 90-day period prescribed for the filing of a petition with this Court.

The period for filing a petition with this Court is jurisdictional and cannot be extended. Here, the petition for redetermination of the 1981 deficiency must be filed within 90 days after the notice of deficiency is mailed to petitioner. Section 6213. Failure to file within the prescribed period requires that the petition be dismissed for lack of jurisdiction. Blank v. Commissioner, 76 T.C. 400, 403 (1981); Estate of Rosenberg v. Commissioner, 73 T.C. 1014, 1016-1017 (1980); Estate of Cerrito v. Commissioner, 73 T.C. 896, 898 (1980); Stone v. Commissioner, 73 T.C. 617, 618 (1980); Estate of Moffat v. Commissioner, 46 T.C. 499, 501 (1966). Hence, under this statute, in order to be timely filed, the petition must be received at Court in Washington, D.C. on or before the 90th day. Here, it is clear that the petition was not so received. However, section 7502(a) provides that if the envelope or wrapper containing the petition bears a U.S. postmark date which is on or before the last day for filing, that postmark date will be deemed the filing date. Here, the U.S. Postal Service postmeter stamp date is January 18, 1985, a date long beyond the 90-day filing period prescribed by law.

Jurisdiction is a matter that must be determined by the Court at any time a question arises with respect thereto, either on a motion by a party or on the Court's own motion. Brannon's of Shawnee, Inc. v. Commissioner, 69 T.C. 999, 1004, and 71 T.C. 108, 111-112 (1978); National Committee to Secure Justice, Etc. v. Commissioner, 27 T.C. 837, 839 (1957). Thus petitioner's argument that respondent's motion to dismiss was filed late is inapposite.

We conclude that this Court does not have jurisdiction for the years 1979 and 1980 because those years were previously disposed of by order of this Court; that this Court does not have jurisdiction for the year 1981 because a timely petition was not filed; and that this Court does not have jurisdiction for the years 1982 through 1984 because notices of deficiency were not issued for those years. Therefore, on this record, respondent's motion will be granted.

An appropriate Order of Dismissal for Lack of Jurisdiction will be entered.

COMPLETED
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742-B

Ju 11.7/2:1986-29

wf 107

T. C. Memo. 1986-29

UNITED STATES TAX COURT

RICHARD F. PICHE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 18749-84. Filed January 23, 1986.

Richard F. Piche, pro se.

Sandra M. Gilmore, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DRENNEN, *Judge*: This case was assigned to Special Trial Judge Peter J. Panuthos pursuant to the provisions of section 7456(d)[1] and Rule 180, et seq.[2] After review of the record, we agree with and adopt his opinion which is set forth below.

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

[2] All Rule references are to the Tax Court Rules of Practice and Procedure.

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OPINION OF THE SPECIAL TRIAL JUDGE

PANUTHOS, Special Trial Judge: This matter is before the Court pursuant to the Mandate of the United States Court of Appeals for the Second Circuit, filed April 26, 1985, remanding this case for "the limited purpose of resolving taxpayer's claim for deductions."

Prior Proceedings

On September 21, 1984, we granted respondent's Motion to Dismiss for Failure to State a Claim Upon Which Relief Can be Granted and Motion Requesting Damages Under Section 6673. In our Order of Dismissal and Decision we found as follows:

> ORDERED AND DECIDED (1) that there are deficiencies in petitioner's Federal income taxes and additions to the tax for the taxable years in the amounts as follows:

		Additions to Tax		
Year	Deficiency	Sec.6651(a)	Sec. 6653(a)	Sec. 6654
1981	$15,089.00	$3,772.25	$ 754.45	$1,201.78
1982	$15,380.11	$2,721.20	$ 769.00	$ 950.30

> (2) that damages are due from the petitioner which are hereby awarded to the United States in the amount of $5,000 pursuant to section 6673, I.R.C. of 1954, as amended.

The "limited remand" by the United States Court of Appeals was based upon a Motion for Limited Remand filed by the Assistant Attorney General on behalf of the Commissioner of Internal Revenue. This motion was in response to the appeal taken by petitioner.

In his motion for limited remand, the Commissioner directed the attention of the Court of Appeals to petitioner's request for a pretrial conference in order to stipulate to itemized deductions to which he claimed to be entitled. The Commissioner stated as follows:

> We suggest that * * * [the Court of Appeals] may find it appropriate to remand this case to the Tax Court for the limited purpose of enabling that court to consider and address taxpayer's claim as to deductions to which he may be entitled for the tax years in question. * * *[3]

The Court of Appeals ordered that the motion filed by respondent be granted and that the matter be remanded to the Tax Court for the limited purpose of resolving petitioner's claim for deductions.

Action on Remand

Pursuant to the limited remand, the Court issued an order on May 31, 1985, requiring the parties to confer for the purpose of reaching agreement with respect to the itemized deductions claimed by petitioner. Further, we ordered that the parties file on or before July 17, 1985, a document reflecting the settlement of this matter. We further ordered that, if the parties were unable to reach an agreement with respect to petitioner's claim for itemized deductions, a hearing would be held on July 24, 1985, in Washington, D.C. for disposition of this matter. On July 23, 1985, the Court received a status report from respondent. Respondent advised that, taking into consideration the allowance to petitioner of certain itemized deductions, the parties had arrived at an agreement with respect to the deficiency and additions to tax. Respondent further advised that petitioner refused to sign documents reflecting this agreement, essentially because he disputed the damage award under section 6673.[4] Attached to respondent's status report filed with the Court on July 24, 1985, was respondent's computation for entry of decision in this matter.[5]

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[3] We note that in a footnote the Commissioner stated that the award of damages under section 6673 was justified in light of the petitioner's tax protest arguments.

Deficiencies and Additions to Tax

Pursuant to the Mandate of the United States Court of Appeals, we provided petitioner an opportunity to present evidence with respect to his entitlement to itemized deductions. No documents have been filed by the parties reflecting an agreement as to the proper deficiency and additions to tax. Furthermore, petitioner did not appear or present any evidence at the hearing held on this matter on July 24, 1985. Nevertheless, based upon representations made by the parties it appears that respondent concedes that petitioner is entitled to certain claimed deductions for the taxable years in issue.[6]

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[4] This information was confirmed in a conference call on the same date. Accordingly, the parties filed memoranda of law with respect to the section 6673 issue.

[5] It is further noted that on August 9, 1985, the Court received a copy of a letter from respondent addressed to the petitioner in which the petitioner was sent a stipulation of settled issues. To the Court's knowledge, the stipulation has not been executed by the parties or filed with the Court.

[6] Respondent filed a computation for entry of decision on July 24, 1985, seeking deficiencies and additions to tax which are (footnote continued)

Accordingly, we find the following deficiencies and additions to tax as set forth in respondent's computation for entry of decision:

		Additions to Tax		
Year	Deficiency	Sec. 6651(a)	Sec. 6653(a)	Sec. 6654
1981	$11,996.00	$2,999.00	$ 599.80	$ 919.09
1982	$12,931.00	$2,108.93	$ 646.55	$ 659.31

Damage Award under Section 6673

In our order of September 21, 1984, we awarded damages pursuant to section 6673 in the amount of $5,000. In his memorandum of authorities respondent first argues that, in view of the limited remand, this Court should not reconsider the award of damages. Petitioner argues that the Court is without jurisdiction to reconsider the damage award in light of the limited remand of the Court of Appeals, as that issue is before the Court of Appeals.

We do not agree with either parties' primary position, that is that we cannot now consider the damage award under section 6673. While the remand was for the limited purpose of resolving petitioner's claim for deductions, it is possible that any finding with respect to such claims could affect the question of whether proceedings before this Court have been instituted or

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(footnote continued from previous page)
reduced from the notice of deficiency and from the Courts finding of September 21, 1984. These reduced amounts were apparently based upon submission of information by petitioner to respondent of entitlement to certain itemized deductions. In any event no evidence was presented to the Court to rebut respondent's disallowance.

maintained by petitioner primarily for delay or whether petitioner's position in this proceeding is groundless or frivolous.[7]

Respondent argues, alternatively, that if the Court does reconsider the award of damages under section 6673, then based upon the record in this case, as well as that of prior proceedings before this Court, the filing of the petition and the maintaining of this action was primarily for delay. He argues, therefore, that the damage award should be sustained.

Petitioner argues that the original position of both respondent and this Court was that petitioner's position was frivolous. Petitioner argues that respondent now abandons his original position, that the petition was frivolous or groundless, and raises a new claim that the petition was filed primarily for delay which is outside the scope of remand.[8]

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[7] We also reject petitioner's argument that, because of the limited remand, we are without jurisdiction to consider the damage award issue. In this regard petitioner's argument is similar to respondent's; the result of accepting either position would leave intact the damage award as found in our order of September 21, 1984.

[8] We again reject petitioner's argument. Respondent's motion seeking damages under section 6673 was filed on August 13, 1984. Since the filing of that motion and its original consideration by this Court, additional facts have been presented for consideration. Some of these facts are the very basis for the remand, that is the issue of petitioner's entitlement to additional itemized deductions. Accordingly, this issue is not a new one, and we may consider all facts and circumstances in its application.

In his memorandum in support of the damage award, respondent presented additional relevant information concerning petitioner's previous proceedings in this Court.[9] We discuss these facts as they relate to the application of the damage award.

A notice of deficiency was issued to Richard F. Piche and Marie M. Piche on March 22, 1982 relating to a deficiency for the taxable year 1978 in the amount of $4,151.13. A timely petition was filed by Mr. and Mrs. Piche at docket number 13774-82. In a statement of error and facts in support thereof, petitioner stated as follows in their petition:

> 4. The determination of the tax set forth in said notice of deficiency is based upon the following errors: The respondent is attempting to collect an additional tax as set out in the Notice of Deficiency (exhibit A) by arbitrary assessment devoid of correct facts and figures absent any factual information to determine said deficiency; and said Notice is barred by Statute of Limitations. * * *

On April 12, 1982, respondent issued a notice of deficiency to Richard F. Piche for the taxable years 1979 and 1980 determining deficiencies and additions to tax as follows:

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[9] Respondent attached numerous exhibits to his memorandum. While these documents have not been offered into evidence, they relate to facts extracted from prior docketed cases. The Court may take judicial notice of such facts. Furthermore, petitioner in his various pleadings and arguments admits to many of the allegations. Petitioner has not disputed any of respondent's allegations as they relate to prior litigation. See Rules 201(c),(d),(e) and (f), Federal Rules of Evidence; Syndes v. Commissioner, 74 T.C. 864, 868 n.5 (1980), affd. 647 F.2d 813 (8th Cir. 1981); Kinnett Dairies, Inc. v. Farrow, 580 F.2d 1260, 1278 n.33 (5th Cir. 1978); St. Louis Baptist Temple, Inc. v. F.D.I.C., 605 F.2d 1169, 1172 (10th Cir. 1979); Hart v. Commissioner, 730 F.2d 1206, 1207 n.4 (8th Cir. 1984); Hicks v. Commissioner, T.C. Memo. 1970-267.

		Additions to Tax	
Year	Deficiency	Sec. 6653(a)	Sec. 6651(a)
1979	$3,520.28	$ 604.11	$ 880.07
1980	$4,149.20	$ 706.60	$1,037.30

The basis for the deficiencies and additions to tax was that petitioner failed to file income tax returns for the years in issue. Respondent determined that Mr. Piche received wages in those years of approximately $35,000 and $38,000, respectively. On July 9, 1982, petitioner filed a petition seeking redetermination of these deficiencies which was assigned at docket number 16990-82. In paragraph 4 thereof he stated as follows:

> 4. The determination of the tax set forth in the said notice of deficiency is based upon the following errors: The respondent is attempting to collect a tax as set out in the Notice of Deficiency (exhibit A) by arbitrary assessment devoid of all facts absent any factual information [sic] to determine what amounts, if any, are due in said deficiency; and in addition, the alleged penalties provided by section 6653(A) and 6651(A), fail to set forth any facts or evidence to support the position that the underpayment of any alleged tax was due to negligence or intentional disregard of rules and regulations, by the petitioner; furthermore, the petitioner has facts which will support that any alleged failure to file was due to negligence and acts performed by those officers under the control and direct supervision of the respondent and/or his delegate.

In August of 1983, respondent filed a Motion for Summary Judgment in each of these dockets. As a basis for his motions, respondent argued that petitioners alleged neither justiciable error nor justiciable facts in support of any error as required under Rule 34(b)(4) and Rule 34(b)(5). By notice dated July 8, 1983, these cases were set for trial on the October 3, 1983, trial session at Buffalo, New York. By notice dated August 23, 1983, petitioners were notified that respondent's motions for summary judgment were set for hearing on October 3, 1983.

With respect to docket number 13774-82 involving the taxable year 1978, petitioners apparently presented information to respondent's representatives with respect to expenses claimed on their 1978 return. A stipulated decision was filed by the parties on October 5, 1983, reflecting no deficiency and no overpayment for the taxable year 1978. At some point prior to trial or hearing on respondent's motion, petitioner Richard F. Piche presented schedules reflecting his income and expenses with respect to 1979 and 1980. The parties came to an agreement as to the proper deficiency and additions to tax, and accordingly, filed a stipulated decision with the Court which was entered on February 17, 1984.

With respect to the years in issue, 1981 and 1982, petitioner received wages of $43,508.04 and $46,988.76, respectively. Petitioner failed to file Federal income tax returns for these years. On March 16, 1984, a notice of deficiency was issued with respect to the 1981 and 1982 years which were the subject matter of this case. In his petition, petitioner made numerous protester type arguments.[10] The Court's order of dismissal and decision was entered on September 21, 1984 granting respondent's motion for failure to state a claim upon which relief can be granted and further granting respondent's request for damages under section 6673. Petitioner for the first time specified entitlement to deductions in his motion for reconsideration filed October 22, 1984.[11]

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[10] These arguments are more fully set forth in our prior order.

After this matter was remanded and we issued our order dated June 5, 1985, petitioner, for the first time, on July 11, 1985, submitted Forms 1040 for the taxable years 1981 and 1982 which reflected wage income in the amounts of $43,508 and $46,989, respectively.

Section 6673 provides as follows:

> When it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as part of the tax.

In Abrams v. Commissioner, 82 T.C. 403, 410 (1984), we held as follows:

> It is clear under the statute that taxpayers can delay proceedings in this Court by means other than raising frivolous or groundless positions. Delay by such other means may, likewise, subject a taxpayer to an award of damages.

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[11] It is noted that attached to his motion for reconsideration, petitioner attached various schedules of a 1981 and 1982 return, however, petitioner did not attach a face page reporting his wage income. The Court denied petitioner's motion on October 26, 1984.

The record in this case overwhelmingly leads us to the conclusion that the proceedings have been instituted and maintained by petitioner primarily for delay. Petitioner attempted to utilize the Court on this occasion as well as on two prior occasions as an agency for the filing of returns and claiming deductions. Petitioner has failed to present information concerning his entitlement to deductions in a reasonable and timely manner, has failed to file Federal income tax returns, and has continued his arguments that wages are not income. In each docketed case it is apparent that petitioner waited until the very last moment before presenting information to respondent for a proper determination of his Federal income tax. For the years in issue, petitioner did not even file an income tax return acknowledging receipt of wage income until after the initial order of this Court. Petitioner knew or should have known the consequences based upon his prior proceedings in the Court. This Court is not the appropriate vehicle for the initiation of reporting of income and deductions. Petitioner has deliberately delayed the determination and payment of his proper tax liabilities by the filing of the petition and the maintenance of this proceeding.

Based upon the foregoing, we found that damages were due from petitioner in the amount of $5,000 pursuant to section 6673. We find no reason to change that award.

Decision will be entered

for the respondent.

COMPLETED

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742-B

JU 11.7/2:1986-30

MF 107

T. C. Memo. 1986-30

UNITED STATES TAX COURT

WILLIAM G. ROWLES AND VERNA M. ROWLES, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 18656-80. Filed January 23, 1986.

Verna M. Rowles, pro se.

Roger Glienke, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

AARONS, Special Trial Judge: This case was assigned to Special Trial Judge Aarons pursuant to section 7456(d)(3) and Rules 180, 181 and 182[1].

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended and as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

ORIGINAL BEST COPY AVAILABLE

Respondent determined a deficiency in petitioners' Federal income tax for 1977 in the amount of $5,494. By an Amendment to Answer, filed with leave of the Court more than seven months before the trial, respondent seeks an additional deficiency based upon the disallowance of $3,011 for mileage, meals and lodging previously allowed in the Notice of Deficiency. The issues to be decided are: (1) the amount of petitioners' gambling losses in 1977, and (2) whether the foregoing items of travel expense are allowable.

FINDINGS OF FACT

To the extent stipulated the facts are so found. Petitioners resided in Palmdale, California at the time of filing their petition and resided there at the time of trial. During 1977, petitioner William G. Rowles ("William") was employed by Northrop Corporation at Hawthorne, California and his wife, petitioner Verna M. Rowles ("Verna") was a homemaker. Neither William or Verna was a professional gambler engaged in the business of wagering. In 1977, Verna made nine trips to Lake Tahoe, Nevada for gambling purposes, and five trips to Las Vegas, Nevada for gambling purposes. William did not accompany Verna on any of her trips to Las Vegas. William was out of the country on a business assignment at the time of trial. Verna was the only witness in this case.

Petitioners also visited the Santa Anita and Hollywood Park race tracks, in the Los Angeles area, at various times during 1977, and placed bets on those occasions.

The parties have stipulated that petitioners' gambling winnings in 1977 were $42,589.50, including $42,251.10 Nevada winnings and $338.40 Santa Anita winnings. Petitioners reported net wagering winnings of $899. Respondent adjusted the total winnings by adding $41,691 to the $899 figure claimed by petitioners. Respondent allowed gambling losses of $19,225. Petitioners had claimed losses (including travel expense) totaling $41,350. The claimed travel expense was $1,700, as contrasted with the allowance of $3,011 in the Notice of Deficiency, which respondent seeks to disallow in the Amendment to Answer. The claimed race track losses were $2,186.

Respondent's allowance of petitioners' 1977 gambling losses in the amount of $19,225 consisted of the following items:

Checks cashed at casinos	$16,525
Cash on hand	1,200
Bank of America Card cash advances	1,500
Total	$19,225

Petitioners did not cash checks or receive credit card advances at race tracks.

Petitioners support their claim of $41,691 gambling losses by purportedly contemporaneous diaries showing entries of winnings and losses during each of their visits to Nevada in 1977. They support their race track losses by purportedly contemporaneous notations appearing on "official programs" which they received at Santa Anita and Hollywood Park.

The diaries contain entries commencing January 1, 1977 and ending December 29, 1977. The covers of the diaries contain the printed words "Pocket Gaming Diary -- Compliments of Del Webb Hotels". On a printed page, inside the cover of the diaries, the following appears:

> Gaming losses are deductible from your tax returns, up to the amount of winnings, if a schedule is kept by the individual at the time the loss occurred. The Gaming Diary is provided for this purpose. For full details please refer to Revenue Procedure 77-29 issued by the Internal Revenue Service.

Revenue Procedure 77-29 was issued on September 12, 1977 (1977-37 I.R.B. 16).

The Court finds that the diaries were not contemporaneous, and that Verna's testimony to the effect that petitioners' 1977 gambling losses were recorded at or close to the time the losses were incurred lacks credibility[2].

With respect to the travel expense, which respondent seeks to disallow in his Amendment to Answer, no proof was submitted by either party. However at the trial, respondent stipulated that the $3,011 in question is the correct amount actually expended for travel.

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[2] Also in evidence is a document drafted by William, entitled "1977 Tax Account Verna M. Rowles". This document is a handwritten summary of the gambling transactions purportedly occurring in 1977. The document was prepared in 1980 on the basis of the allegedly contemporaneous 1977 diaries.

OPINION

The determinations made by respondent in the notice of deficiency are presumed to be correct. Petitioners bear the burden of establishing error in those determinations. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). However, when respondent pleads new matters in his answer, he bears the burden of proof as to such new matters. Rule 142(a).

Petitioners have failed to carry their burden of proof. Verna testified that the entries of wins and losses were entered in the Pocket Gaming Diaries at or near the time of the respective gambling transactions. She placed her total reliance upon such diaries. The printed reference inside the Diaries to Revenue Procedure 77-29 destroys Verna's credibility and undermines the evidentiary value of the Diaries. Although the publication date of Revenue Procedure 77-29 is not set forth in the Cumulative Bulletin in which it is published (1977-2 C.B. 538), the Court takes judicial notice of the publication of this Revenue Procedure on September 12, 1977 in 1977-37 I.R.B. 16. Moreover, Revenue Procedure 77-29 contains a reference to T.D. 7492 which was approved June 25, 1977 and filed in the Office of Federal Register June 28, 1977. See 1977-2 C.B. 463 and 464. Petitioner's only response to this glaring inconsistency was a reiteration of her statement that the diaries were given to petitioners by the Sahara in early January 1977.

The collapse of Verna's credibility and the absence of any reliable records requires the Court to sustain respondent in his limitation of petitioners' 1977 gambling losses to $19,225. See Schooler v. Commissioner, 68 T.C. 867 (1977).

With respect to the travel expense, respondent has agreed that the amount allowable is $3,011 if any travel expense is legally deductible under these facts. According to respondent, this concession eliminates burden of proof as an issue with respect to travel expense, and leaves only a legal question.

Petitioners conceded in the Stipulation of Facts that they were not in the business of gambling. At trial, the Court gave Verna an opportunity to reconsider this concession, but she reaffirmed it. Respondent contends that a non-professional gambler is not entitled to travel expense under section 212, as an expense "for the production or collection of income." Respondent further points out that section 1.212-1(c), Income Tax Regs., incorporates by reference the tests under section 183 for determining whether petitioners' gambling activities were transactions entered into for the production of income, i.e., for profit.

Respondent relies principally upon the two cases of Shiosaki v. Commissioner, T.C. Memo. 1971-24, affd. 475 F.2d 770 (9th Cir. 1973), and Shiosaki v. Commissioner, T.C. Memo. 1975-28. However, the problem respondent has not escaped from is that, despite the concession as to the $3,011 amount expended for travel, respondent still has the burden of proving that the "for profit" tests under section 183 were not met in this case. The Shiosaki cases, supra, involved a non-professional gambler who went to Las Vegas frequently in the years at issue. He suffered losses and had consistently suffered losses over a period of many years. In the instant case, petitioners ended up in 1977 with claimed winnings of $899, and with winnings exceeding $20,000 as a result of our conclusions herein. There is nothing in the record as to petitioners' pattern of winnings and losses in other years.

It is our view that the burden of proof placed upon respondent by his Amendment to Answer leaves more than just a question of law. Respondent had the burden of proving facts which would negate the "for profit" tests of section 183 and section 1.183-2(a) and (b), Income Tax Regs. Respondent failed to provide such proof.

In accordance with the foregoing we sustain the deficiency in the amount asserted in the notice of deficiency, i.e., $5,494. We reject respondent's claim for an additional deficiency.

An appropriate order and decision will be entered.

COMPLETED
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Ju 11.7/2:M186-31

MF 10)

T. C. Memo. 1986-31

UNITED STATES TAX COURT

ROY F. RICKARD AND MIA T. RICKARD, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27079-85. Filed January 23, 1986.

The envelope containing the petition filed herein was mailed from Daytona Beach, Florida, and was postmarked by a private postage meter. The postmark is dated the 89th day after the notice of deficiency was mailed to Ps. The petition was received and filed at the U.S. Tax Court on the 102d day.

Held, Ps failed to prove they met the requirements of sec. 301.7502-1(c)(1)(iii)(b), Proced. & Admin. Regs.; accordingly, under secs. 7502(b) and 6213(a), I.R.C. 1954, the petition was not timely filed. R's Motion to Dismiss for Lack of Jurisdiction is granted.

William Randolph Klein, for the petitioners.

Avery B. Cousins, III and Phyllis W. Greenblum, for the respondent.

ORIGINAL

MEMORANDUM OPINION

FEATHERSTON, Judge: Respondent's Motion to Dismiss for Lack of Jurisdiction filed herein was assigned to Special Trial Judge Francis J. Cantrel for hearing, consideration and ruling thereon. After a review of the record, we agree with and adopt his opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

CANTREL, Special Trial Judge: This case is before the Court on respondent's Motion to Dismiss for Lack of Jurisdiction filed on September 25, 1985.[1]

Respondent, in his notice of deficiency issued to petitioners on April 4, 1985, determined a deficiency in petitioners' Federal income tax for the taxable calendar year 1981 in the amount of $151,113.59.

The record herein discloses that on April 4, 1985 respondent by certified mail issued a notice of deficiency to petitioners at their last known address pursuant to section 6212,[2] addressed as follows: 2684 John Anderson Drive, Ormond Beach, Florida 32074.

Section 6213(a), which permits the filing of petitions with this Court, provides in part:

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[1] This case was assigned pursuant to sec. 7456(d)(4), Internal Revenue Code of 1954, as amended, and Delegation Order No. 8, 81 T.C. XXV (1983).

[2] All section references are to the Internal Revenue Code of 1954, as amended.

> Within 90 days * * * after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. * * *

The 90th day after the mailing of the notice of deficiency was Wednesday, July 3, 1985, which date was not a legal holiday in the District of Columbia. The petition herein, which is dated July 2, 1985, was received by the Court on July 15, 1985, and filed on that date. The envelope in which the petition was received by the Court was properly addressed, postage prepaid, and it bears a clearly legible private postage meter stamp date which reads "Daytona Beach, Fla. JUL-2 '85." There is no evidence in this record that the envelope containing the petition was deposited in the mails of the U.S. Postal Service at Daytona Beach, Florida on July 2, 1985 or July 3, 1985.

Petitioners filed an objection to respondent's motion on October 11, 1985 and upon consideration of that document we find it to be meritless. Respondent, by and through his motion and at the hearing at Washington, D.C. on December 4, 1985, urges that we dismiss this case as the petition was not timely filed within the time prescribed by sections 6213(a) and 7502(b) and the regulations issued thereunder. On this record, we must and do agree with respondent.

A petition for redetermination of a deficiency must be filed with this Court within 90 days after the notice of deficiency is mailed to a taxpayer. Section 6213. Failure to file within the prescribed period requires that the petition be dismissed for lack of jurisdiction. Estate of Rosenberg v. Commissioner, 73 T.C. 1014, 1016-1017 (1980); Estate of Cerrito v. Commissioner, 73 T.C. 896, 898 (1980); Stone v. Commissioner, 73 T.C. 617, 618 (1980); Cassell v. Commissioner, 72 T.C. 313, 316-317 (1979); Estate of Moffat v. Commissioner, 46 T.C. 499, 501 (1966).[3] Hence, under this statute, in order to be timely filed, a petition must be received at Court in Washington, D.C., on or before the 90th day. It is clear that the petition was not so received.

However, section 7502(a) provides that if the envelope or wrapper containing the petition bears a U.S. postmark date which is on or before the last day for filing, the postmark date will be deemed to be the filing date. The date on which the envelope was actually placed in a U.S. Post Office box is not the date of filing under section 7502(a). Estate of Moffat v. Commissioner, supra at 501. Here, the envelope in which the petition was received bears no postmark placed thereon by the U.S. Postal Service, but does bear a private metered mail stamp which has a date of July 2, 1985 on it. In such circumstance, we must proceed to section 7502(b), which mandates--

> This section shall apply in the case of postmarks not made by the United States Postal Service only if and to the extent provided by regulations prescribed by the Secretary.

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[3] See paragraphs (a) and (c) of Rule 13, Tax Court Rules of Practice and Procedure. See also Wiese v. Commissioner, 70 T.C. 712 (1978), involving a late legible private postage meter postmark.

Thus, following the mandate, and to resolve the controversy herein, we next turn to section 301.7502-1(c)(1)(iii)(b), Proced. & Admin. Regs., which sets forth the conditions under which section 7502 applies to privately metered mail.[4] This regulation provides that privately metered mail showing a date within the 90-day period (which is the situation herein) is considered timely filed if it is received within the ordinary delivery time for mail postmarked at the same place of origin by the U.S. Postal Service. Whether the petition was received at the Tax Court in the ordinary delivery time is purely a factual question. Leventis v. Commissioner, 49 T.C. 353, 355 (1968); Stotter v. Commissioner, 69 T.C. 896, 899 (1978).[5] As the trier of fact, we must evaluate the evidence in the light of our own "experience with the mainsprings of human conduct to the totality of the facts of each case." Commissioner v. Duberstein, 363 U.S. 278, 289 (1960). The burden of proving that the Court has jurisdiction is on petitioners although the Court has extended its Rules on when and what kind of evidence can be received in the determination. Cassell v. Commissioner, supra at 317-318.

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[4] The regulations under sec. 7502(b) have been held to be valid. See Fishman v. Commissioner, 51 T.C. 869, 872-873 (1969), affd. per curiam 420 F.2d 491 (2d Cir. 1970); Lindemood v. Commissioner, 566 F.2d 646, 649 (9th Cir. 1977), affg. a Memorandum Opinion of this Court.

[5] These cases, in which we maintained jurisdiction, are factually distinguishable from the case at bar. In each of those cases a timely private postage meter stamp was involved. In Leventis v. Commissioner, 49 T.C. 353 (1968), a Columbia, South Carolina mailing was received and filed 3 days and 9 hours after the expiration of the 90-day filing period. In Stotter v. Commissioner, 69 T.C. 896 (1978), a Philadelphia, Pennsylvania mailing was received and filed 3 days and 8 hours beyond the period provided for filing. Neither of these cases involved a weekend filing deadline.

Respondent, at paragraph 5 of his motion asserts--

> The United States Postal Service has advised the respondent that an envelope, which was properly addressed to the Tax Court, mailed from the Ormond Beach, Florida area and bearing a United States Postmark with a date of July 3, 1985, would have ordinarily been received on July 5, 1985 at the Tax Court.

Respondent's statement as to the service standards of the United States Postal Service is not sufficient to support a finding of fact that mail from either Daytona Beach, Florida or Ormond Beach, Florida (which are approximately 10 miles apart) would ordinarily be received at the Tax Court in Washington, D.C. within 2 days, as respondent contends. On the other hand, there is no evidence in this record (and understandably so) suggesting that the normal delivery time from those two sites is as much as 13 days, as petitioners would have us believe. In these circumstances, we must conclude that the petition herein was delivered after the time when a document so mailed and so postmarked, as here, would ordinarily be received.[6]

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[6] See the following cases where we declined jurisdiction in holding that the mailing period was not ordinary: Estate of Labovitz v. Commissioner, T.C. Memo. 1985-538, involving an 8-day mailing period from Blue Bell, Pennsylvania; Estate of Reiners v. Commissioner, T.C. Memo. 1981-275, involving an 8-day mailing period from Morris, Minnesota; Berry v. Commissioner, T.C. Memo. 1981-106, involving a 7-day mailing period from Augusta, Georgia; Levison v. Commissioner, T.C. Memo. 1979-470, involving an 8-day mailing period from New York, New York.

Since petitioners' mail was not received within the ordinary time for delivery the burden of proof is upon them to establish three facts:

> (i) that it [the document] was actually deposited in the mail before the last collection of the mail from the place of deposit which was postmarked (except for the metered mail) by the United States Post Office on or before the last date, or the last day of the period, prescribed for filing the document,
>
> (ii) that the delay in receiving the document was due to a delay in the transmission of the mail, and
>
> (iii) the cause of such delay.

[Section 301.7502-1(c)(1)(iii)(b), Proced. & Admin. Regs.]

The burden of proving that these factors are met is on petitioners. Fishman v. Commissioner, 51 T.C. 869, 873 (1969), affd. per curiam 420 F.2d 491 (2d Cir. 1970). Petitioners have established none of these facts. On this record, respondent's motion will be granted.

We are mindful that this result is harsh, but as the Court stated in Lindemood v. Commissioner, 566 F.2d 646, 649 (9th Cir. 1977), affg. a Memorandum Opinion of this Court:

> The regulation states explicitly that the taxpayer must establish the cause of the delay in the receipt of his document. It leaves no room for exceptions or judicial interpretation. Appellants' argument that it is sufficient that they showed the delay was not their fault is contrary to the plain meaning of the regulation. A similar argument was rejected in Irving Fishman, 51 T.C. 869 (1969), affd. per curiam 420 F.2d 491 (2d Cir. 1970).[7]

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[7] We close in providing, inter alia, the following admonition found in Lindemood v. Commissioner, supra at 649: "In section 301.7502-1, the Secretary of the Treasury attempted to provide relief designed to counter the potential ability of the user of a (footnote continued)

An appropriate order of dismissal for lack of jurisdiction will be entered.

(footnote continued from previous page)
private postage meter to abuse the good intentions of 26 U.S.C. Sec. 7502 by applying any postmark convenient for his purposes." See also *Wiese v. Commissioner*, *supra* at 713. Moreover, petitioners could have protected themselves by mailing their petition by certified or registered mail. See sec. 7502(c) and sec. 301.7502-1(c)(2), Proced. & Admin. Regs., and *Estate of Moffat v. Commissioner*, 46 T.C. 499, 502 (1966). Finally, petitioners need not be denied their day in court as they may pay the deficiency, file a claim for refund, and, if the claim is denied, sue to recover in the United States District Court for the locale in which they live or the U.S. Claims Court at Washington, D.C. See *Drake v. Commissioner*, 554 F.2d 736, 739 (5th Cir. 1977).

COMPLETED

M42-13

Ju 11.7/2: 1986-32

mf104

T. C. Memo. 1986-32

ORIGINAL

UNITED STATES TAX COURT

ROGER ELI FERRIS, Petitioner *v*. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4700-85. Filed January 27, 1986.

Roger Eli Ferris, pro se.

Michael Kevin Phalin, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

AARONS, Special Trial Judge: This case was assigned to Special Trial Judge Aarons pursuant to section 7456(d)(3) and Rules 180, 181 and 182[1].

Respondent determined a deficiency in petitioner's 1981 Federal income tax in the amount of $3,365. After concessions by both parties reflected in the Stipulation of Facts, the remaining issues are the deductibility as ordinary and necessary business expenses of pilot proficiency expenses, disability insurance premiums and certain checking account charges. Also involved is the availability of a claimed investment tax credit.

FINDINGS OF FACT

To the extent stipulated, the facts are so found. At the time his petition was filed, petitioner resided in Blue Jay, California. He still resides there.

Petitioner is an airline transport pilot employed by Western Airlines. He is rated by the Federal Aviation Administration (FAA) as qualified to fly DC-10's, B-737's, B-727's and single engine planes, his last increase in rating having occurred in 1978. In 1979, petitioner purchased a Cessna 310P which he owned and used during 1981. In 1981, petitioner purchased various new and used navigation and other instruments for the Cessna, which are the subject of the investment tax credit herein at issue.

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

In 1981, petitioner flew the Cessna 15.8 hours on local flights and 21.4 hours cross-country for a total of 37.2 hours. Although the record is not wholly clear as to the purpose of some of the local flights, the Court finds that the local flights were primarily for various types of flying practice. The cross-country flights, except as noted below, were from airports in the Los Angeles area either to Las Vegas or Reno, Nevada, and return to the Los Angeles area. Petitioner owned a home in Las Vegas and had lived there previously with his former wife. Petitioner traveled to Reno to try to work out a potential partnership arrangement, the nature of which is not apparent from the record.

Petitioner was not required by his employer or by the FAA to own his own aircraft or to engage in private flying. However, petitioner's flying proficiency was refreshed and maintained by his use of a smaller aircraft. Because of the extremely high degree of automation in the large commercial aircraft, there is some risk of a pilot losing the "feel" for flying which he finds in a smaller aircraft.

Petitioner could have flown free or at a reduced price from Los Angeles to Las Vegas or Reno and return on commercial flights but chose to use his Cessna. The Court finds that although petitioner derived some proficiency benefit from those "cross-country" trips, his primary purpose was to "get there" for personal reasons (in the case of Las Vegas) or investigating the possibility of a new partnership (in the case of Reno).

One of the cross-country flights, of 1.7 hours duration, was for the purpose of practicing night landings and was primarily for proficiency purposes.

The "Pilot Proficiency Expenses" claimed by petitioner on his 1981 return were:

Aircraft Depreciation	$13,014.37
Hanger Rental	1,419.65
Fuels	1,530.72
Maintenance/Repair	1,697.77
Taxes	139.37
Miscellaneous	3,692.89
Parts/Material	282.02
Books/Manuals	
Inspections	672.18
Insurance	1,463.00
Total Expense	$23,911.97

In addition, petitioner claimed as business expense $20 (representing half of his checking account charges); disability insurance premiums of $818 (a " flight officers' disability income" policy providing for a monthly benefit of $1,000 in case of total disability); and an investment tax credit on the instruments installed in the Cessna in the amount of $656. None of the dollar amounts are in dispute. Respondent has disallowed these items because they assertedly are not sufficiently related to a trade or business carried on by petitioner.

OPINION

For the reasons set forth fully in Boser v. Commissioner, 77 T.C. 1124 (1981), affd. in an unpublished opinion (9th Cir., December 22, 1983),[2] which we need not spell out again here, we think it is clear that some of the expenses relating to petitioner's operation of the Cessna come within the meaning of the term "education" as used in section 1.162-5(a), Income Tax Regs., and further that this type of expense meets the "ordinary" requirement of section 162. The obstacle confronting petitioner, as in Boser v. Commissioner, supra, is satisfying the "necessary" requirement of section 162. As set forth in that case at page 1133:

> To the extent that an expense is unreasonable, it is not necessary. In such case, only the portion which was reasonable is deductible under section 162. United States v. Haskel Engineering & Supply Co., 380 F.2d 786, 788-789 (9th Cir. 1967).

Petitioner has the burden of proving the extent to which he incurred expenses for maintaining his proficiency. Rule 142(a). As set forth in our Findings of Fact, petitioner has not persuaded the Court that the cross-country trips to Las Vegas were other than primarily personal. Nor is the Court satisfied that Reno cross-country trips were for a primary purpose other than investigating the possibility of a new, and unidentified, partnership. Taking into account the 1.7 hours of cross-country flying that the Court finds were for practice flying, this leaves petitioner with a total of 19.7 hours in 1981 of primarily personal flying time in the Cessna and a maximum of 17.5 hours of primarily proficiency flying time in that year. As the Court concluded in Boser v. Commissioner, supra, we conclude here that, although petitioner is entitled to an educational expense deduction under section 162, such deduction is to be based on an allocation of actual expenses, plus depreciation, between business use of 17.5 hours, and the total hours petitioner flew his aircraft during 1981, i.e. 37.2 hours. This amount should be agreed upon by the parties in the Rule 155 computation. We further hold that the claimed investment tax credit in the amount of $818 should be allowed in the same proportion as 17.5 hours bears to 37.2 hours.

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[2] Footnote 5 in Boser v. Commissioner, 77 T.C. at 1134, which is relevant to the instant case, was modified by an Erratum notice at 79 T.C. II (1982).

Respondent's disallowance of the disability insurance premiums must be sustained under Blaess v. Commissioner, 28 T.C. 710 (1957), followed in Andrews v. Commissioner, T.C. Memo. 1970-32. Each of these cases held that premiums on similar policies were not deductible business expenses under section 162. The Court has considered whether such premiums might qualify as a medical expense under section 213. However, petitioner listed no medical expense on his return, nor does he claim such premiums as a medical deduction. See, in this connection, section 1.213-1(e)(4)(i)(a), Income Tax Regs., denying deductibility under section 213 of premiums on policies providing an indemnity for loss of income.

With respect to the $20 item representing a portion of petitioner's checking account charges, the record contains no evidence sufficient to carry petitioner's burden of proof. Rule 142(a).

To reflect the foregoing conclusions, as well as the concessions of the parties,

Decision will be entered
under Rule 155.

COMPLETED

742-B

Ju 11.7/2: 1986-33

MF 104

ORIGINAL

T. C. Memo. 1986-33

UNITED STATES TAX COURT

KENNETH L. AND MILDRED V. FULLER, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 5722-85. Filed January 27, 1986.

Where Tax Court has no jurisdiction it may not entertain a motion for award of reasonable litigation costs.

William L. Raby, for the petitioners.

Roger Rhodes, for the respondent.

MEMORANDUM OPINION

CANTREL, Special Trial Judge: We have before us for consideration and ruling thereon a Motion for Award of Reasonable Litigation Costs, filed by counsel for petitioners' on December 31, 1985.[1] The Court will decide that motion herein. See Rule

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[1] That motion was assigned pursuant to sec. 7456(d)(4), Internal Revenue Code of 1954, as amended, and Rule 180, Tax Court Rules of Practice and Procedure.

50(b)(3).[2]

It has long been settled that a valid petition may not be filed in the Tax Court without the issuance of a valid statutory notice of deficiency, sometimes referred to as a "ticket" to the Tax Court. Midland Mortgage Co. v. Commissioner, 73 T.C. 902, 907 (1980); Baron v. Commissioner, 71 T.C. 1028, 1034 (1979); Jones v. Commissioner, 62 T.C. 1, 2 (1974); Corbett v. Frank, 293 F.2d 501 (9th Cir. 1961).[3]

"[W]e have jurisdiction to determine if we have jurisdiction at any time, be it before or after final decision is entered." Brannon's of Shawnee, Inc. v. Commissioner, 71 T.C. 108, 111-112 (1978). "[Q]uestions of jurisdiction which go to the root of all subsequent action * * * and should be disposed of at the threshold * * * must be dealt with by the Tax Court, like other tribunals, on its own motion even if not raised by either party." National Committee to Secure Justice, Etc. v. Commissioner, 27 T.C. 837, 839 (1957).

On December 6, 1985 counsel for the parties filed a Stipulation and a Joint Motion to Dismiss for Lack of Jurisdiction. At paragraph 5 of the Stipulation it is recited--"The parties agree that the January Notice issued in this case is invalid in its entirety insofar as it attempts to determine a deficiency for TEFRA partnership items other than through the procedures prescribed by secs. 6221 through 6233."[4] At paragraph 3 of their joint motion counsel assert--"No valid statutory notice of deficiency under I.R.C. sec. 6212 was issued to petitioners for the taxable year 1982."

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[2] All Rule references are to the Tax Court Rules of Practice and Procedure.

[3] We observe that venue on appeal of this case would lie in the United States Court of Appeals for the Ninth Circuit.

After careful consideration of the record in this case in its entirety we granted the joint motion and the case was dismissed for lack of jurisdiction on the ground that the statutory notice of deficiency was invalid.[5] Hence, since the deficiency notice is invalid, no valid petition may be filed with this Court based thereon. This simply means that this Court cannot acquire jurisdiction of this case. Having no jurisdiction, we have no authority to entertain petitioners' pending motion and, as a consequence, it must be denied. The mere filing of the petition cannot, for any purpose, breathe life into the cadaver.[6]

Moreover, section 7430, appertaining to the awarding of court costs and certain fees provides, in pertinent part--

> (a) In General.--In the case of any civil proceeding which is--

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[4] All section references are to the Internal Revenue Code of 1954, as amended.

[5] The Chief Judge signed the Order of Dismissal for Lack of Jurisdiction which was entered and served on December 17, 1985.

[6] See and compare McLane v. Commissioner, 46 T.C. 140, 145 (1966), affd. per curiam 377 F.2d 557 (9th Cir. 1967).

> (1) brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, and
>
> (2) brought in a court of the United States (including the Tax Court and the United States Claims Court),
>
> the prevailing party may be awarded a judgment for reasonable litigation costs incurred in such proceeding.[7]

In short, based on the foregoing statute, and since we have no jurisdiction, there is no civil proceeding before this Court and there can be no prevailing party within the meaning of section 7430(c)(2)(A) to whom a judgment award may be made.

An appropriate order

will be issued.

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[7] Also see sec. 7430(e) which provides--"An order granting or denying an award for reasonable litigation costs under subsection (a), in whole or in part, shall be incorporated as a part of the decision or judgment in the case and shall be subject to appeal in the same manner as the decision or judgment." [Emphasis added.] It is obvious that no decision or judgment can be entered in this case.

COMPLETED

742-B

Ju 11.7/2: 1986-34

mf104

T. C. Memo. 1986-34

UNITED STATES TAX COURT

WARREN MATHIS AND BARBARA MATHIS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 12823-84. Filed January 27, 1986.

William Norton Baker, for the petitioners.

A. Shawn Noonan, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, *Judge*: Respondent determined a deficiency in petitioners' Federal income tax for the taxable year 1980 in the amount of $2,365.45. The only issue presented is whether petitioners realized a short-term capital gain in connection with the purchase of real property.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and the exhibits attached thereto are incorporated herein by reference.

Warren Mathis and Barbara Mathis (petitioners),[1] husband and wife, resided in Texas on May 7, 1984, the date the petition was filed in this case. They filed their joint Federal income tax return for the calendar year 1980 with the Internal Revenue Service Center in Austin, Texas. In addition to other business activities, petitioners, along with Hershel and Octavia Carthel (parents of Barbara Mathis and hereinafter "Carthels") jointly engaged in farming operations.

J. B. Smith (Smith), beginning in 1963, operated the East Mound Gin, Inc. (Gin), on land near petitioner's farm. Smith had purchased this land for $675 per acre. During the mid-1970's, Smith offered J.C. Eiring (an adjoining landowner) about $1,200 per acre to purchase a portion of Mr. Eiring's farm. That offer was rejected.

Thereafter, Mr. Eiring died and petitioner and Smith discussed purchase of a 287.45-acre tract of Eiring's farm. In November 1979, Smith and petitioner agreed to make a bid to purchase the Eiring farm, and that Smith would take title to approximately 46 acres[2] if they were successful in bidding for the property at the estate sale. The parties estimated that the land would sell for between $850 and $1,050 per acre and agreed that Smith would pay the successful bid price.

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[1] When we refer to "petitioner," we refer to Mr. Mathis.

[2] This is apparently the same parcel of land that Smith had attempted to purchase before Mr. Eiring's death.

The estate sale was held on December 6, 1979. Petitioner attended the estate sale alone, since Smith was busy ginning cotton. During October, November, and December, cotton gins are required to operate long hours to keep up with the harvest. Petitioner was the successful bidder at the estate sale, and he entered into a contract with the Hale County State Bank, Plainview, Texas, for the purchase of 287.45 acres of land (the Eiring farm), together with all fixtures and improvements thereon for a price of $930 per acre. On January 15, 1980, the Hale County State Bank, as executor of Eiring's estate, conveyed the 287.45 acres and improvements to petitioners and the Carthels for a total consideration of $267,328.50.

Petitioners and the Carthels allocated $48,120 of the $267,328.50 purchase price to the improvements, all of which were on the portion of the 287.45 acres which petitioner had agreed to purchase.[3] Eight hundred fifty-seven dollars and fifty-three cents in expenses were incurred in connection with the purchase of the 287.45-acre tract.

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[3] It appears that the parties were well aware that the improvements on the Eiring farm were not on the portion Smith agreed to acquire.

On February 19, 1980,[4] petitioners and the Carthels conveyed 46.15[5] acres of the 287.45-acre tract to the Gin for the bid price of $930 per acre. Approximately one-half (20-25 acres) of the 46.15-acre portion acquired by the Gin contained a playa lake. In the deed to the Gin, petitioners and the Carthels reserved a 20-foot easement for the purpose of operating, maintaining, and reconstructing irrigation pipelines then existing on the tract, and an easement to take and use surface water from the lake.

Petitioners, on the theory that the 287.45 acres of land had been bought together with the Carthels and the Gin, did not report any gain or loss on their 1980 Federal income tax return in connection with the transfer or sale of the 46.15-acre tract to the Gin. Respondent, by a deficiency notice mailed on April 16, 1984, determined that the transfer to the Gin by petitioner was a sale which resulted in gain, 50 percent of which should be reported by petitioner. Respondent determined that the petitioners' and Carthels' adjusted basis in the land sold to the Gin was $36,931.57. This amount was derived by reducing the purchase price for the entire 287.45-acre tract by the $48,120 allocated by petitioner and the Carthels to the improvements on the real property; adding the $857.53 expenses of purchase; and then dividing the remainder by the total number of acres (287.45), and multiplying that times the number of acres sold to the Gin.[6]

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[4] Some discrepancy exists as to when the land transfer between petitioner and the Gin (Smith) was completed. Smith suffered a severe heart attack in Jan. 1980, and petitioner had an operation and was hospitalized in March. Petitioner testified that the deal was not closed until after he was released from the hospital, but the deed transferring the property is dated Feb. 19, 1980.

[5] Although the statutory notice of deficiency reflects 48.24 acres of land transferred to the Gin, the correct amount, as agreed by the parties, is 46.15 acres.

Petitioners contend that the oral agreement between petitioner and Smith either caused the purchase of land to be a "joint venture type of arrangement" or permitted petitioner to act as an agent for all the parties in bidding on the property at the estate sale. Alternatively, petitioner contends that if we determine that he purchased the property and subsequently sold it to the Gin, then the allocation on a per-acre basis of the real property should either be done at the time of the purchase (including the value of the improvements) or that the value of the property ultimately acquired by the Gin is in excess of the $930 per-acre purchase price because of prior offers by the Gin to purchase the land.

Respondent contends that petitioner purchased the land and sold it to the Gin. Further, respondent contends that the basis in the land is cost, reduced by the amount of improvements, and increased by the amount of expenses incurred in the purchase.

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[6] Petitioners claimed a depreciation deduction on their 1980 Federal income tax return in connection with the $48,120 in improvements on the acreage purchased from the estate.

Petitioners and respondent basically agree that each acre of the 287.45 acres had substantially the same value at the date of the transfer to the Gin.[7]

OPINION

After a careful examination of the record, we find that the transfer of property from petitioner to the Gin was not a separate sale or exchange giving rise to short-term capital gain under section 1001, I.R.C. 1954. Accordingly, we need not address the parties' contentions regarding proper basis computation and allocation.

Whether a sale has taken place is a question of fact. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). In making this factual determination, we must focus on what was actually done. In doing so, the intent of the parties must be examined. Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).

The basic facts as set forth in this opinion are simple. Petitioner and Smith reached an oral agreement to try to purchase land at the estate sale.[8] Each party had expressed interest in a portion of the land to be sold. The land, however, could be purchased only in its entirety.

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[7] It is assumed that petitioners agree that each acre of land had substantially the same value on the date of sale for purposes of their primary position but not the alternative where they contend that if the land is allocated subsequent to the reduction of the improvements that the 46.15 acres transferred to the Gin had a higher value and were worth the $930, being the price at which petitioner sold them to the Gin.

Petitioner attended the sale alone. At the sale, bids were accepted per-acre. Petitioner successfully bid $930 per acre for the tract in its entirety. This bid was well within the range previously agreed to by petitioner and Smith, and over $200 per acre less than Smith had previously offered for the land. Petitioner initially took title to the land in his name only.[9]

Pursuant to their plan, petitioner transferred approximately 46 acres of land to Smith at the bid price, about $930 per acre.[10] We decline to find that this subsequent transfer of a portion of the land made pursuant to the agreement between petitioner and Smith was a sale or exchange separate and distinct from the original land purchase at the estate sale.[11]

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[8] The enforceability of the agreement between petitioner and Smith is not at issue here. At the time of the deficiency notice, the agreement was wholly executed by both parties. As such, this Court makes no findings regarding the enforceability of such agreement had it been executory.

[9] The fact that petitioner initially took title to the land in his own name is not determinative. Shwiff v. Priest, 650 S.W.2d 894, 900 (Tex. Civ. App. 1983).

[10] In determining whether the transfer of land from petitioner to Smith, dated Feb. 19, 1980, was a separate sale and therefore subject to the incidence of taxation, we must consider the substance of the transaction. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

The facts of this case in substance indicate that only the purchase of land took place, beginning with the negotiations between petitioner and Smith and ending with the transfer of land to Smith. Petitioner and Smith agreed to buy land, and purchased the land according to their agreement.[12]

Decision will be entered for the petitioners.

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[11] We are cognizant that petitioner and Smith entered into this transaction in a rural setting, where informality in business is not unusual. Although lawyers could have readily obviated the need for this controversy, we are inclined to respect taxpayers' customs and practices where, as here, the net effect of the parties' agreement was effected, albeit in an unsophisticated and cumbersome manner. See Young v. Commissioner, T. C. Memo. 1985-221, wherein the Court commented: "[W]e think the informality of these * * * transactions in Floyd County, Virginia, as described by petitioner, is entirely consistent with the rural setting and practices * * * in that area of Virginia."
[49 TCM 1439, 1444, 1985 P-H Memo T.C. par. 85,221 at 981.]

[12] Both men testified at trial. Petitioners' counsel, in his closing argument, succinctly summarized the testimony:

> Admittedly, they were not lawyers or detail people, but they knew what they were doing. Mr. Mathis was going to go to the auction, buy the property, and the gin was going to take what they needed there at the same price per acre as was paid at the auction.
>
> * * *
>
> The gin had been trying to buy that property for twelve or $1400 an acre for several years. This is really just a joint venture where they went together and bought the property and then they split it up after they bought it. It was nothing more and nothing less.

COMPLETED

742-B

Ju 11.7/2: 1986-35

MF104

T. C. Memo. 1986-35

UNITED STATES TAX COURT

ROBERT P. DIMMERS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3208-85. Filed January 27, 1986.

Robert P. Dimmers, pro se.

Gail Gibson, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: Respondent, by a statutory notice, mailed November 15, 1984, determined deficiencies in income tax and additions to tax as follows:

		Additions to Tax		
Year	Deficiency	Sec. 6651(a)[1]	Sec. 6653(a)	Sec. 6654
1979	$5,749.71	$ 833.58	$287.49	$114.32
1980	7,297.71	1,418.79	364.89	335.76
1981	5,060.00	1,216.58	253.00*	369.17
1982	3,307.00	589.17	165.35**	206.32

* Sec. 6653(a)(2): 50 percent of interest due on $4,866.30
** Sec. 6653(a)(2): 50 percent of interest due on $2,356.67

The issues presented for our consideration are as follows: (1) Whether petitioner's wages from services as a large machine operator and certain unemployment benefits are income; (2) whether petitioner can substantiate various itemized deductions; and (3) whether petitioner is liable for additions to tax under sections 6651(a), 6653(a), and 6654 for each of the taxable years 1979 through 1982.

Robert P. Dimmers (petitioner) was a resident of White Bear Lake, Minnesota, at the time of filing the petition herein. Petitioner does not dispute that he failed to file income tax returns for the taxable years 1979, 1980, 1981 and 1982. In the petition, he alleged that his wages were not taxable income because they constituted "an equal exchange for labor." At the trial, petitioner declined to state a position or offer any evidence concerning why his wages were not taxable, stating that respondent had threatened to move the assertion of damages (up to the amount of $5,000) if petitioner asserted or maintained a frivolous or groundless position.[2] Respondent conceded, with respect to the taxable year 1979, that the amount of income determined in the statutory notice ($22,480.73) should be reduced by $552. With that exception, we find respondent's determination of income for the taxable years 1979, 1980, 1981 and 1982 to be correct because petitioner has failed to carry his burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Rule 142. Further, petitioner's argument that compensation for labor is not subject to tax is wholly without merit and has been addressed by this Court on numerous occasions and by the Eighth Circuit Court of Appeals. Funk v. Commissioner, 687 F.2d 264 (8th Cir. 1982); Broughton v. United States, 632 F.2d 706, 707 (8th Cir. 1980), cert. denied 450 U.S. 930; Hayward v. Day, 619 F.2d 716, 717 (8th Cir. 1980), cert. denied 446 U.S. 969 (1980); Rowlee v. Commissioner, 80 T.C. 1111, 1120 (1983).

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

With respect to petitioner's claimed deductions, respondent's statutory notice reflects that the amount of tax was computed by means of the tax table, which includes a "built-in" zero bracket amount. Because petitioner had not filed for the years in issue he submitted, prior to the trial of this case, various documents to respondent and respondent has agreed that petitioner is entitled to itemize deductions in specified amounts which, in all years, exceed the standard deduction. The following itemized deductions have been conceded by respondent:

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[2] Petitioner had requested that he be allowed to file a brief and was permitted until Nov. 12, 1985, to file a seriatim brief. Petitioner did not file a brief or provide any explanation for his failure to do so. Because briefs were to be seriatim, no responsive brief is due from respondent.

Item	1979	1980	1981	1982
State Income Tax	$1,557.71	$ 387.95	$1,480.67	$ 894.96
Real Estate Taxes	793.08	686.05	592.43	807.23
Sales Taxes	134.00	153.00	139.00	129.00
Auto License	24.57	---	33.13	51.22
Mortgage Interest	1,348.61	1,050.87	1,126.39	1,142.81
Community Credit Interest	242.30	204.21	548.83	559.13
1st State Bank of Hugo - Interest	---	---	164.54	24.99
Wards - Interest	---	62.48	---	---
VISA - Interest	---	---	73.60	---
Union Dues	---	262.00	---	170.00
Total Allowed by Respondent	$4,100.27	$2,806.56	$4,158.59	$3,779.34

At the time of trial, petitioner asserted that he was entitled to additional deductions which were not reflected on respondent's scheduled allowances. Based upon concessions by respondent and evidence submitted by petitioner, we find the following deductions allowable in addition to the amounts outlined by respondent in his schedule: For the taxable year 1979, petitioner is entitled to an additional $156 for union dues. For the taxable year 1980, petitioner is entitled to the following amounts in addition to those allowed by respondent: $117.35 for sales tax and $33.01 for automobile licensing. For the taxable year 1981, petitioner is entitled to an additional $29.96 for automobile licensing and $170 for union dues. With respect to the taxable year 1982, petitioner is entitled to an additional $25.39 for automobile licensing and interest to the First State Bank of Hugo in the amount of $65.33.

Petitioner stated that he had claimed 1,080 miles of business related travel for taxable years prior to 1979, when he had filed returns. When requested to provide detail about the number of trips, whether the trips were between jobs as opposed to from his home to a job, petitioner was not able to provide sufficient detail or explanation that would permit the allowance of any amount for business related travel. Petitioner also claimed that he was entitled to an additional deduction with respect to interest on credit card accounts. He proposed to offer checks written to these creditors which did not delineate any amount as being attributable to interest, as opposed to principal. Further, petitioner did not have any recall or actual knowledge of whether those accounts carried interest or whether finance charges were asserted during any of the taxable years in question concerning these creditors. In view of the foregoing, petitioner has failed to carry his burden of proof with respect to any additional amounts of interest or travel expense beyond that allowed by respondent. Welch v. Helvering, supra; Rule 142.

Respondent has determined additions to tax with respect to sections 6651(a) (failure to file), 6653(a) (negligence) and 6654 (failure to pay estimated tax). It is clear from the admissions of petitioner and the record in this case that petitioner failed to file a return without good cause and that, at very least, such failure was due to negligence and willful disregard of the rules and regulations. In addition, petitioner has offered no evidence or explanations as to why these additions to tax should not be imposed. In view of the foregoing, we find that the additions to tax under sections 6651(a), 6653(a) and 6654 are appropriate for the taxable years 1979, 1980, 1981 and 1982. Further, we find that for the years 1981 and 1982, the addition to tax with respect to section 6653(a)(2) is applicable.

To reflect the foregoing,

Decision will be entered

under Rule 155.

742-B

Ju 11.7/2:1986-36

JAN 30 1986 37

mf 105

T. C. Memo. 1986-36

UNITED STATES TAX COURT

CHALLENGE PUBLICATIONS, INC., Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4393-82. Filed January 28, 1986.

Petitioner is a magazine publisher and it sold its magazines to a distributor, which, in turn, consigned the magazines to local wholesalers to distribute to local newsstands. Petitioner billed the distributor for the magazines shipped and agreed to extend credit to the distributor for unsold magazines. Petitioner accrued the aggregate sales price of the magazines it shipped during each respective taxable year as gross income for that taxable year. Petitioner also accrued as a deduction its estimate of the magazines that it anticipated would be returned to it. Held, petitioner's dealings with its distributor were on a sale or return basis, not a consignment basis. Held further, petitioner properly accrued as income the gross sales price of magazines shipped. Held further, respondent properly disallowed petitioner's claimed deductions for anticipated returns of unsold magazines.

Irving M. Grant and V. Joseph Stubbs, for the petitioner.

Michael C. Cohen, for the respondent.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

STERRETT, Chief Judge: By notice of deficiency dated December 4, 1981, respondent determined deficiencies in petitioner's Federal income taxes as follows:

Tax Year Ended	Deficiency
9/30/72	$ 546,278
9/30/73	931,546
9/30/74	292,313
9/30/75	1,321,821
9/30/76	1,434,840

After concessions, the issues before the Court are: (1) whether petitioner's dealings with its distributor were on a consignment basis or on a sale or return basis, (2) whether petitioner properly accrued as income the gross sales price of magazines shipped to wholesalers, and (3) whether respondent properly disallowed petitioner's claimed deductions for anticipated returns of unsold magazines.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

Petitioner, Challenge Publications, Inc., is a California corporation, which incorporated on October 17, 1963. During the years in issue, and at all relevant times, petitioner maintained its principal place of business in Canoga Park, California. Petitioner's books and records were kept and its Federal income tax returns were prepared and filed on an accrual method of accounting. The returns for the taxable years at issue were filed with the Internal Revenue Service at Fresno, California.

Petitioner was, and continues to be, engaged in the business of publishing magazines that are sold to consumers through traditional newsstands and other retail outlets, and by subscription. Each of petitioner's magazines (with the exception of "one-shots" as hereinafter described) is published with regular frequency. One-shots are magazines that have a special theme and are published by petitioner on a one-time basis. One-shots are sold only at newsstands and at other retail outlets, but not by subscription.

Petitioner derived its revenues from the sale of advertising space and sales of its magazines. The vast majority of petitioner's magazine sales were made at the wholesale level to a national distributor, Publishers Distribution Corporation (hereinafter referred to as "PDC"), which, in turn, consigned the magazines to local wholesalers for distribution to local retailer newsstands.

Petitioner first began using PDC as its national distributor for one of its magazines pursuant to a contract dated March 18, 1971. Subsequently, petitioner entered into identical agreements with PDC with respect to its other magazines. The pertinent provisions of the distribution agreement with PDC are as follows:

> 1. PUBLISHER AGREES:
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> * * *
>
> (d) to bill Distributor for copies delivered at

* * [cents] per copy, * * * and to credit Distributor for returns of all unsold copies evidenced by full copies, or front covers, or headings, or wholesaler affidavits, at the same price.

* * *

2. DISTRIBUTOR AGREES:

* * *

(b) to pay Publisher on the basis of net sales of each issue, less Distributor's credits, as follows:

* * *

1. An advance of 25% within 10 days after receipt of completion of shipping card.
2. Settlement 70 days after off sale subject to additional returns which will be charged to succeeding issues.[1]
3. Thirty (30) days after off-sale date of each issue, an amount not to exceed 80% of the balance remaining from the Distributor's estimate of net sale, less all previous advances.

* * *

3. THE PARTIES AGREE:

* * *

(i) The loss, damage, or destruction to copies of said publication, or evidence of returns of unsold copies, while in transit, or in Distributor's possession, shall be at the risk of the Publisher.

(j) This contract shall be construed to effect a consummated sale to Distributor of copies shipped F.O.B. to Distributor's consignees, subject only to the provisions hereof. Publisher and Distributor shall be creditor and debtor hereunder, respectively. No provision hereof shall be construed to constitute or appoint Distributor or its consignees as Publisher's agent.

(k) Publisher hereby authorizes Distributor to accept from Distributor's wholesalers and other sales outlets, front covers and/or headings as full evidence of unsold copies of said publication. Publisher further grants Distributor sole discretion to accept affidavits from Distributor's wholesalers and other sales outlets, provided such affidavit specifies the quantity of unsold copies of the particular issue for which credit is requested from Distributor. Publisher shall credit Distributor for all unsold copies evidenced by the aforesaid return provisions, as well as full copy return procedure hereinabove provided.

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[1] A substantial number of copies of each issue of petitioner's magazines were returned by the final settlement date. If, however, returns were made or reported after the final settlement date, petitioner accepted and paid PDC for such returns.

> (1) Approximately every 10 days following the off-sale date of each issue, Distributor shall furnish Publisher with a statement specifying the quantity of returns, as hereinabove provided, received by Distributor during said period. Publisher shall accept said statements as correctly reporting the quantity of said returns unless within 30 days after the date of mailing or delivery of said return statement to Publisher, Publisher mails or delivers to Distributor written objection to the accuracy of said return statement. * * *

On November 14, 1973, petitioner and PDC executed a new agreement that superseded all prior agreements, although the agreement, which covered all of petitioner's magazines, was substantially the same as the previous set of agreements. The November 14, 1973 agreement between petitioner and PDC was superseded by a new agreement dated April 9, 1976, which again was similar in substance to the prior agreements.[2]

At all relevant times, it was the general practice in the publishing industry for publishers to print and deliver to distributors' wholesalers for ultimate distribution to newsstands substantially more copies of magazines than were expected to be sold by the newsstands, and to accept returns of all unsold magazine copies. During each of the years in issue, petitioner printed and delivered for sale availability at newsstands substantially more copies of its magazines than the newsstands ultimately sold and accepted returns of all unsold copies. Petitioner's reasons for overprinting included the desire by petitioner, PDC and the wholesalers to maximize exposure and maximize sales, and to achieve the widest distribution possible. The number of copies of each of petitioner's magazines to be printed and distributed for sale availability at newsstands was determined by petitioner in conjunction with PDC. These copies were then shipped directly from petitioner's printer to PDC's wholesalers. At that time, or shortly thereafter, petitioner would send to PDC an invoice reflecting the gross sales price to PDC of magazines shipped to PDC's wholesalers.

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[2] The settlement date, however, was moved from 70 to 90 days from off sale. Also, PDC was required to submit return statements every 7 days instead of every 10 days.

Petitioner determined the "on-sale" date with respect to each issue of each magazine. This was intended to be the date that each issue was delivered by the wholesaler to the retailer and placed on the retailer's newsstand or otherwise made available for sale. In most cases, the retailers abided by the on-sale date by making petitioner's magazines available for sale on such date. The "off-sale" date with respect to each issue of each magazine was the on-sale date of the next succeeding issue of such magazine, unless otherwise provided in petitioner's distribution agreement with PDC.

At the time the retailer received a new issue of one of petitioner's magazines, the retailer would replace all unsold copies of the preceeding issue with copies of the new issues. These unsold copies would then be returned by the retailer to the wholesaler who, in turn, would return or report such copies to PDC. Generally, the wholesaler would verify to PDC the number of returns from retailers by sending a portion of the cover of each magazine returned. At times, however, PDC simply accepted an affidavit from the wholesaler as to the number of returns. PDC would then furnish petitioner, at 10-day or 1-week intervals, with reports of returns of unsold copies with respect to each magazine.

During all of the taxable years in issue, petitioner consistently reflected on its books and on its Federal income tax returns income from its newsstand sales as a net amount. Petitioner accrued the aggregate sales price of the magazines it shipped during each respective taxable year as gross income for that taxable year. Petitioner also accrued as a deduction its estimate of the number of magazines shipped that it anticipated ultimately would be returned to it.[3]

In his notice of deficiency, respondent disallowed petitioner's claimed deductions for estimated returns of unsold magazines. Respondent's disallowance was based upon his determination that petitioner was not entitled to a reduction in income for the anticipated return of publications which were not actually returned until the subsequent year.

OPINION

Issue One: Sale or Return vs. Consignment

In order to determine the amount petitioner must include in income from its sales of magazines, we must characterize the nature of the contracts executed between petitioner and PDC that were in effect during the taxable years in issue. Specifically, the issue is whether the contracts were contracts of sale with the right of PDC to return the unsold magazines (i.e., sale or return contracts), or consignment contracts that created an agency in PDC to sell magazines for petitioner. Petitioner contends that they were consignment contracts and not contracts of sale. As a result, petitioner maintains that income accrued when the magazines were actually sold by retail newsstands and not when the magazines were shipped to the wholesalers.

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[3] During the taxable years in issue, petitioner's estimates of returns exceeded actual returns. The cummulative amount by which its estimated returns exceeded actual returns totaled $505,445, and petitioner failed to reflect this amount in its gross income.

The characterization of the contracts between petitioner and PDC is determined from the intention of the parties at the time that the respective contracts were executed.[4] Lipsky v. Commonwealth United Corp., 551 F.2d 887, 896 (2d Cir. 1976); Ross v. H. Michaelyan, Inc., 57 F.2d 674, 675 (2d Cir. 1932); Oil Trading Associates, Inc. v. Texas City Refining, Inc., 201 F.Supp. 846, 849 (S.D.N.Y. 1962). Our examination of the three contracts in evidence[5] convinces us that the parties intended to enter into sale or return contracts and not consignment contracts. The March 18, 1971 and November 14, 1973 contracts each set out in unambiguous language that--

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[4] Although petitioner's place of business was in California, the contracts stated that they were to be construed in accordance with the laws of New York. In any event, we note that California law is in accord with New York law on this point. Pacific Gas & Electric Co. v. G.W. Thomas Drayage & Rigging Co., 69 Cal.2d 33, 69 Cal. Rptr. 561, 564 n.5, 442 P.2d 641, 644 n.5 (1968); see also Cal. Civ. Code section 1636 (West 1985).

[5] The parties stipulated that these contracts were representative of all such contracts entered into between petitioner and PDC during the years in issue.

> [t]his contract shall be construed to effect a consummated sale to Distributor of copies shipped F.O.B. to Distributor's consignees, subject only to the provisions hereof. Publisher and Distributor shall be creditor and debtor hereunder, respectively. *No provision hereof shall be construed to constitute or appoint Distributor or its consignees as Publisher's agent*.[6] [Emphasis added.]

Furthermore, Lawrence Manheimer, who was president and chairman of the board of PDC during the years 1972 to 1975, testified that, with respect to the March 18, 1971 and November 14, 1973 distribution contracts, PDC did not want to be petitioner's agent.[7]

The manner in which petitioner treated its transactions with PDC supports our finding that these were sale or return contracts. At the time petitioner shipped its magazines to the wholesalers, or shortly thereafter, petitioner sent an invoice to PDC reflecting the gross sales price to PDC of such magazines shipped and accrued in income the amount of the gross sales price. Had petitioner been operating on a consignment basis, it would have reported income when the retailer sold the magazines. Moreover, if petitioner had been operating on a consignment basis, it would have had to include all consigned magazines in its ending inventory. Sec. 1.471-1, Income Tax Regs.[8]

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[6] The April 9, 1976 contract had a similarly worded clause.

[7] Since Mr. Manheimer was not president when the April 9, 1976 contract was entered into, he could not testify with respect to that particular contract. Nothing in the record, however, indicated that PDC desired to be petitioner's agent at that later date.

[8] Sec. 1.471-1, Income Tax Regs., specifically requires that (footnote continued)

Petitioner failed to do this.[9] Finally, under the Uniform Commercial Code, as adopted by New York law, petitioner unquestionably operated under a "sale or return," as opposed to a consignment basis. N.Y. U.C.C. sections 2-326, 2-327 (McKinney 1964).[10]

We note that petitioner simply has not established that an agency relationship existed under each contract, rather than a sale. Neither PDC, the wholesalers nor the retailers were known to be substantially engaged in the sale of goods of others. Even though petitioner determined the resale prices at which the retailers would sell its magazines, this does not prove that each merchant was acting as an agent of petitioner under a consignment contract.[11]

(footnote continued from previous page)
"[m]erchandise should be included in the inventory only if title thereto is vested in the taxpayer * * * but should exclude from inventory goods sold * * * title to which has passed to the purchaser."

[9] For all the taxable years in issue, petitioner's income tax returns indicated that it did not have any inventory on hand at the end of its taxable year.

[10] N.Y. U.C.C., section 2-326(1)(b) provides that "[u]nless otherwise agreed, if delivered goods may be returned by the buyer even though they conform to the contract, the transaction is a 'sale or return' if the goods are delivered primarily for resale"; and section 2-327(2)(a) provides that "[u]nder a sale or return unless otherwise agreed the option to return extends to the whole or any commercial unit of the goods while in substantially their original condition * * *."

[11] See J.J. Little & Ives Co. v. Commissioner, T.C. Memo. 1966-68.

Petitioner contends that the agreements entered into with PDC were consignment contracts and cites Handfield v. Commissioner, 23 T.C. 633 (1955), as support for its contention. In Handfield, the taxpayer, a nonresident Canadian individual, manufactured post cards. He had a contract with the American News Company whereby the latter distributed his cards to newsstands in the United States for sale to the public. The principal issue was whether the taxpayer was engaged in business in the United States. In deciding this issue, the Court first determined the nature of the contractual arrangement between the taxpayer and the news company. The Court analyzed the contract, which was embodied in a letter, and found that the taxpayer sold its products on a consignment basis. Its holding was based primarily upon the following factors:

> (1) The distributor was not obligated to buy any definite amount of merchandise from the taxpayer and was obligated to account only for merchandise which had been sold,
> (2) All unsold merchandise could be returned,[12]
> (3) The taxpayer bore all transportation costs,
> (4) The taxpayer gave full credit for all post cards sold regardless of their condition,
> (5) The distribution agreement controlled the retail price, and
> (6) The distributor had the right to discontinue selling the cards when sales were slow.[12]

See Handfield v. Commissioner, supra at 637.

Upon close examination, Handfield is distinguishable from the instant case. The record in Handfield was extremely meager as the Court had only the contract between the taxpayer and

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[12] It should be mentioned that factors (2) and (6) are also present in a sale or return contract.

American News Company and a few stipulated facts from which to determine the nature of the arrangement. In addition, the contract was silent with respect to whether or not a completed sale or consignment had taken place. In contrast, we had a full record before us in determining the nature of the contracts. Each of the contracts set forth in clear and unambiguous language that it effected a consummated sale to PDC of magazines shipped to PDC's consignees and that neither PDC nor its consignees were agents of petitioner. Moreover, the president of PDC testified that PDC did not intend to be petitioner's agent. Finally, the evidence demonstrated that petitioner treated its transactions with PDC on a sale or return basis, not on a consignment basis.

Having determined that petitioner made a sale of each shipment of magazines under a sale or return contract, we next must determine the amount of income that petitioner must include in its gross income during each of the taxable years in issue.

Issue Two: Accrual of Income

Generally, under the accrual method of accounting, income is included in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 (1934); secs. 1.446-1(c)(1)(ii), 1.451-1(a), Income Tax Regs. Under a sale or return contract, petitioner is required to report the income from the sale of merchandise upon delivery of such merchandise to its customers. Record Wide Distributors, Inc. v. Commissioner, 682

F.2d 204, 206 (8th Cir. 1982), affg. a Memorandum Opinion of this Court.[13] It is the right to receive payment, not the actual receipt, that determines whether income has accrued and must be includable in the gross income of an accrual basis taxpayer. *Commissioner v. Hansen*, 360 U.S. 446, 464 (1959); *Spring City Foundry Co. v. Commissioner*, *supra* at 184. Subsequent uncollectibility of the accrued sales income does not prevent its inclusion in gross income. See *Spring City Foundry Co. v. Commissioner*, *supra* at 185, which stated, "[i]f such accounts receivable become uncollectible, in whole or part, the question is one of deduction which may be taken according to the applicable statute."[14]

Facts similar to the instant case also were present in *Record Wide Distributors, Inc. v. Commissioner*, *supra*. In that case, the taxpayer was in the business of selling phonograph records, 8-track tapes, and cassette tapes to wholesalers and retailers. At the time the taxpayer shipped goods to a customer, an invoice also was sent showing the amount, description, and price of the items sold. The taxpayer guaranteed to its customers that they could return any unsold items for full credit. The taxpayer also did not require any payment for records and tapes until its customers had sold all the products it could and then returned the unsold merchandise.

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[13] *Record Wide Distributors, Inc. v. Commissioner*, T.C. Memo. 1981-12. See also *J.J. Little & Ives Co. v. Commissioner*, T.C. Memo. 1966-68; *Scott Krauss News Agency, Inc. v. Commissioner*, T.C. Memo. 1964-171.

[14] Under sec. 458 (effective only for taxable years beginning after September 30, 1979) an accrual basis distributor of magazines may elect to exclude from gross income the income attributable to magazines returned within 2 months and 15 days after the close of the taxable year in which the sales were made. Although not effective for the taxable years in issue, the legislative history indicates that under pre-section 458 law petitioner is required to include the income from the sale of magazines in gross income when they are shipped to PDC's wholesalers, irrespective of the number of returns. H. Rept. No. 95-1800 (Conf.), 1978-3 C.B. (Vol. 1) 521 (1978).

One of the issues presented was the proper tax treatment of the sale of goods under the accrual method of accounting. With respect to this issue, the Eighth Circuit found that the taxpayer, who dealt with its customers on a "sale or return" basis, had to include in income the invoice amounts upon delivery of the merchandise.[15] Accordingly, we find that the gross sales price of the magazines shipped accrued as income to petitioner at the time of shipment.

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[15] We note that petitioner argues that, because of its return policy, all events had not occurred at the time of shipment which established its right to receive any certain amount of income. It maintains that its right to receive income occurred at the off-sale date because it was then that the actual number of magazines sold for which petitioner was entitled to payment were determined. This argument was raised and rejected in Record Wide Distributors, Inc. v. Commissioner, 682 F.2d 204, 206 (8th Cir. 1982), affg. a Memorandum Opinion of this Court, as it found that the taxpayer was confusing the uncertainty of the time and actual payment with the right to receive payment.

Issue Three: Deduction for Anticipated Returns

The next issue that we must decide is whether petitioner properly took a deduction for magazines that it anticipated would be returned to it by PDC. Petitioner argues that its method of accounting clearly reflected income because it was in accordance with generally accepted accounting principles and followed the general industry practice. Thus, it maintains that respondent improperly disallowed its claimed deductions. Petitioner also contends that its accrual of deductions for estimated returns was proper because it satisfied the requirements of sections 446[16] and 461. This is, by far, the most difficult issue we must resolve.

Accounting for sales and returns of magazines is governed by sections 446 and 461. Section 446(a) provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Section 446(b) provides, however, that if the method used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such methods as, in the opinion of the [Commissioner], does clearly reflect income."

The Commissioner's power to determine whether the accounting method used by a taxpayer clearly reflects income is broad. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 533 (1979);

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[16] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

Commissioner v. Hansen, 360 U.S. 446, 467 (1959). Just because a method of accounting employed by a taxpayer is in accord with generally accepted accounting principles[17] and practices does not mean that for income tax purposes it so clearly reflects income as to be binding on the Commissioner. American Automobile Assn. v. United States, 367 U.S. 687, 693 (1961). This is particularly true when a taxpayer seeks to deduct an estimated reserve because financial accounting, which has as its purpose the providing of information with respect to a company's financial condition, "is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty." Thor Power Tool Co. v. Commissioner, supra at 543-544. Accordingly, whether petitioner properly deducted as an expense its estimate of anticipated returns to it by PDC depends upon whether the requirements of section 461 were met.

Section 461(a) states the general rule that a taxpayer is allowed a deduction in "the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." For purposes of determining that "proper taxable year," section 1.461-1(a)(2), Income Tax Regs., sets forth what has become known as the "all-events" test[18] and provides in part as follows:

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[17] We note that from the record it is not entirely clear that petitioner's method of accounting was in accordance with generally accepted accounting principles. Specifically, petitioner failed to reflect in income the amount of its estimated returns that exceeded actual returns.

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. * * * While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. * * *

The "all-events" test presents two hurdles that petitioner must satisfy before it properly can take a deduction for anticipated returns of magazines. First, petitioner must establish that all events that determine the fact of liability must have occurred as of the end of the year for which it seeks to accrue the liability. This requirement prevents the deduction of an expenditure that might never be made. Second, as of the end of the year for which petitioner seeks to accrue the liability, petitioner must be able to estimate with reasonable accuracy the amount of the expenditure to be made in the subsequent year. See Burlington Northern Railroad Co. v. Commissioner, 82 T.C. 143, 147 (1984); Ohio River Collieries Co.

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[18] The "all-events" test was first enunciated by the Supreme Court in United States v. Anderson, 269 U.S. 422, 440-441 (1926). See Nightingale v. United States, 684 F.2d 611, 614-615 (9th Cir. 1982); Burlington Northern Railroad Co. v. Commissioner, 82 T.C. 143, 146 (1984).

v. Commissioner, 77 T.C. 1369, 1372-1373 (1981). Failure to satisfy either requirement of this two-prong test would be fatal to petitioner's claim.

With respect to the first prong of the "all-events" test, petitioner contends that, under its distribution agreements, its liability to accept, and allow credits for, refunds of unsold magazines was fixed and unconditional as of the time it shipped magazines to PDC's wholesalers.

Under the March 18, 1971 and November 14, 1973 distribution agreements executed between petitioner and PDC, petitioner agreed "to credit [PDC] for returns of all unsold copies [of magazines] evidenced by full copies, or front covers, or headings, or wholesaler affidavits * * *."[19] Furthermore, PDC was required to obtain from each wholesaler evidence of returns, either in the form of magazine covers or affidavits, and it also was required to notify petitioner of returns on a frequent basis (generally every 10 days).[20] These services performed by PDC were an integral part of its relationship with petitioner. Thus, it is clear that notification of unsold magazines was a condition precedent to petitioner's liability to credit PDC for unsold magazines. The fact that unsold magazines typically were returned to petitioner does not change the fact that, in the absence of such return, petitioner was under no obligation to extend credit to PDC. Thus, from the time of shipment until such notification of unsold magazines was received by petitioner, its liability to PDC was contingent, not fixed.

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[19] The April 9, 1976 contract was similarly worded.

[20] See findings of fact at pages 3-5.

We note that our situation is substantially similar to the facts in Ertegun v. Commissioner, 531 F.2d 1156 (2d Cir. 1976), affg. a Memorandum Opinion of this Court.[21] In Ertegun, the taxpayer was a wholesaler of records and sold merchandise to approximately 60 distributors. Under the terms of sale, 41 of these distributors had a right to return unsold records to the taxpayer after the end of each calendar quarter and receive a credit from the taxpayer. The invoice on the sales of records stated that no merchandise was returnable "without written authorization from this office." The authorization for the return of the records was then issued, generally within 2 to 3 weeks after the end of the quarter. These distributors were guaranteed that unsold merchandise would be accepted by the taxpayer, up to an amount equal to 10 percent of the distributor's purchases from the taxpayer in the quarter which had just ended. In preparing its tax return, the taxpayer reduced its gross income by the amount of credit that the taxpayer anticipated it would have to extend for records sold during the last quarter of its taxable year, but which were to be returned in the subsequent taxable year.

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[21] Ertegun v. Commissioner, T.C. Memo. 1975-27.

Respondent disallowed the deduction on the basis that the taxpayer's liability for such allowance was contingent as of the end of its taxable year. The taxpayer argued that its anticipated 10-percent credit could be accounted for at the time the records were sold because its credit policy, in practice, amounted to an expected automatic 10-percent liability for each record it sold during the last quarter of its taxable year. Hence, the taxpayer maintained that, as of the end of its taxable year, its liability for returns was fixed and certain so that it was entitled to accrue the deduction. The Second Circuit found that the agreement between the taxpayer and its distributors was a sales contract with an option to return unsold merchandise, and that the taxpayer's credit liability was not incurred until the time that the unsold merchandise actually was returned.

Petitioner argues that Ertegun is distinguishable from the instant case. It maintains that the taxpayer in Ertegun required the actual returns of records for the allowance of credits because such returns reduced its royalty obligations to its recording artists. Since the taxpayer derived an economic benefit from the return of unsold records by the distributors, such returns were not "ministerial" acts. In contrast, petitioner insists that it derived no such economic benefit from the return of its unsold magazines. Since those returns did not result in any reduction of petitioner's costs, and were in fact later destroyed, petitioner contends that its requirement that it be notified of unsold magazines was merely a ministerial act. We disagree.

Petitioner required notification of unsold magazines as a condition precedent to its granting PDC credit. This requirement served a substantial function because it enabled petitioner to insure that it was giving PDC credit only for unsold magazines. Thus, petitioner clearly derived an economic benefit from its receipt of notification of unsold magazines before giving PDC credit.

Petitioner further argues that Ertegun is distinguishable from the instant case because in Ertegun the sales invoices used by the taxpayer expressly provided that no merchandise could be returned without prior written authorization. Since these return authorizations were not granted until after the close of the taxable year in issue, petitioner maintains that the taxpayer did not have a fixed liability to accept, and allow credits for, returns of unsold records at the time of shipment. We fail to see how the requirement in Ertegun that written authorization be obtained before credit would be extended is different in substance from the requirement in the instant case that notification of unsold magazines be received by petitioner as a condition to it granting PDC credit. The fact that the requirement in Ertegun was expressly stated, whereas in the instant case the requirement was implicit in the contract, does not warrant that the two requirements be treated differently.

Rather, we think that these two requirements are substantially similar in nature and support our finding that petitioner's liability to PDC for unsold magazines was not fixed until notification of unsold magazines was received by petitioner.

Having failed the first prong of the "all-events" test, we need not address the second prong of the "all-events" test. Accordingly, no accrual for anticipated returns of unsold magazines is permitted as it is well established that a reserve for future or contingent liabilities cannot be deducted.[22] Lucas v. American Code Company, 280 U.S. 445, 452 (1930).

We note that petitioner relied heavily upon Gillis v. United States, 402 F.2d 501 (5th Cir. 1968), as support for its contention that it properly took a deduction for magazines that it anticipated would be returned to it by PDC. In Gillis, the taxpayer was a cotton merchant subject to the regulations of the Commodity Credit Corporation (hereinafter CCC). Under certain of these regulations designed to reduce stockpiles of domestic cotton,[23] the taxpayer could obtain cotton from the CCC at a discount from the higher domestic price if it agreed to export the same amount of cotton within a certain period of time. The agreement was backed up by a cash bond in the amount of the difference between the foreign and domestic price of cotton. The bond would be forfeited if the taxpayer either did not sell and export the cotton at the lower foreign price, or buy more cotton at the higher domestic price and export that cotton. The taxpayer deducted the amount of the bond as an accrued expense for the year in which it purchased the cotton, although it did not complete the transaction by exporting the required amount of cotton until the following year. In addition, the taxpayer sold cotton to a foreign corporation pursuant to a contract. Under the contract, the foreign corporation would submit claims to arbitration against the taxpayer if any cotton sold did not conform to the stated specifications. The taxpayer knew, at the time of some shipments, that certain cotton was of substandard quality. Since the taxpayer acknowledged that it was liable for such shipments of inferior cotton, it deducted as an accrued expense its estimate of the amount of the foreign corporation's anticipated claims that were to be submitted.

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[22] As part of the 1954 Code, Congress enacted sec. 462 which permitted taxpayers to deduct reserves for estimated expenses. The principal requirement of the statute was that the estimated expense be attributable to the income of the taxable year and that Treasury was satisfied that the amount of the expense could be estimated with reasonable accuracy. Upon further reflection, however, Congress realized that Treasury would suffer substantial losses as a result of taxpayers switching to the reserve method in the transition year. As a consequence, sec. 462 was repealed retroactively in 1955 by the Act of June 15, 1955, ch. 143, 68 A Stat. 158.

[23] The stockpiles existed because the price of domestic cotton was higher than the price of foreign cotton.

The Court in Gillis found that the bond expense was properly deductible as an accrued expense, since the taxpayer was committed to a fixed obligation in a known amount at the time he entered into a purchase agreement with the CCC. Thus, all the events had occurred which fixed the nature and amount of the taxpayer's obligations. The Court also held that the taxpayer properly deducted its anticipated claims by the foreign corporation as an accrued liability. Since the taxpayer knew, at the time of shipment, that certain cotton was substandard and that claims would be made against it as a result, the Court found that the taxpayer's liability was fixed under the contract at the time of shipment.

Petitioner's reliance on Gillis is misplaced. In that case, the taxpayer knew at the time the cotton was shipped that the cotton was inferior, so that its liability was fixed and certain at the time such cotton was shipped. By contrast, there was no absolute certainty that any of the magazines shipped by petitioner to wholesalers would ultimately be returned as unsold for credit. Thus, at the time of shipment, petitioner's liability was not fixed. Even if we agreed with petitioner's contention that some of the magazines shipped by it to wholesalers were virtually certain to be returned, that still falls short of the absolute certainty required in order for a liability to be fixed, and not contingent.

Petitioner's reliance on Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955), revg. and remanding 17 T.C. 1097 (1952), is equally misplaced. In Pacific Grape Products Co., the taxpayer was a canner of fruit and fruit products and, through brokers, sold its products to wholesalers. The taxpayer treated the brokerage fees relating to the goods that were sold and billed, but undelivered as of the end of each taxable year, as deductible expenses in their respective years.

In denying this deduction, the Commissioner argued that the taxpayer's liability for brokerage fees did not become fixed until the year in which the goods were paid.

At trial, the taxpayer introduced evidence that, with respect to the customary practice of the California Canning Industry, the liability for brokerage fees became fixed when the goods were billed. The taxpayer, however, failed to introduce evidence of its agreements with its brokers. The Tax Court found that the taxpayer failed to carry its burden of proving that the Commissioner's determination was erroneous, noting that the taxpayer's failure to produce the agreements was fatal to its case. Accordingly, the Tax Court upheld the Commissioner's determination. On appeal, the Ninth Circuit reversed us. It found that the taxpayer's introduction of evidence with respect to the California industry practice was sufficient to demonstrate that its liability for brokerage fees was fixed at the time when the goods were billed.

Pacific Grape Products Co. is distinguishable because, in the instant case, the agreements between petitioner and PDC were introduced into evidence. Thus, it is unnecessary to look to the customary practices of the publishing industry to determine when petitioner's liability to PDC for returns of unsold magazines became fixed. Furthermore, the evidence revealed that this liability was contingent at the time of shipment and that it became fixed only upon the subsequent notification of unsold magazines.[24]

To summarize, we find that petitioner must accrue as income, at the time of shipment, the gross sales price of magazines shipped. However, with respect to returns of unsold magazines, petitioner must wait until notification of such returns before it properly can accrue a deduction for this expense.[25] Petitioner maintains that our finding has the effect of mismatching items of income and expense, and thus, fails to clearly reflect income under an accrual method of accounting. Such contention is without merit. The "matching" principle does not overcome the requirements of the "all-events" test for the recognition of income and deductions.[26] See American Automobile Assn. v. United States, 367 U.S. 687 (1961)(the taxpayer was not allowed to allocate prepaid income over the months during which services would be provided and expenses incurred); *World Airways, Inc. v. Commissioner*, 564 F.2d 886 (9th Cir. 1977), affg. 62 T.C. 786 (1974)(the taxpayer was not allowed to allocate the reasonably foreseeable cost of statutorily mandated airplane repairs to the periods in which plane mileage, and revenues, were accumulated).

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[24] Likewise, petitioner's reliance on Crescent Wharf & Warehouse Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975) and Burlington Northern Railroad Co. v. Commissioner, 82 T.C. 143 (1984), is misplaced. Those cases involve fixed statutory liabilities, whereas the instant case involves estimates of possible liabilities.

[25] We note that this Court has consistently held that an accrual for anticipated returns in this situation is not allowable, either as an offset against gross sales or as a deduction from gross income. See J.J. Little & Ives Co. v. Commissioner, T.C. Memo. 1966-68; Scott Krauss News Agency, Inc. v. Commissioner, T.C. Memo. 1964-171.

[26] Petitioner cited numerous cases in support of its contention that the "matching" of items of income and expense is necessary in order for an accrual method of accounting to clearly reflect income. All of these cases relied upon by petitioner are inapposite because in all of those cases the "all-events" test was found, either expressly or impliedly, to have been satisfied.

Decision will be entered
under Rule 155.

742-B

Ju 11.7/2:1986-37

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T. C. Memo. 1986-37

UNITED STATES TAX COURT

GAIL D. BOZEK, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

LAWRENCE M. BOZEK, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 10570-83, 10826-83. Filed January 28, 1986.

Gail D. Bozek, pro se in docket No. 10570-83.

Lawrence M. Bozek, pro se in docket No. 10826-83.

Charles Cobb, for the respondent.

ORIGINAL

MEMORANDUM OPINION

AARONS, Special Trial Judge: These consolidated cases were assigned to Special Trial Judge Aarons pursuant to section 7456(d)(3) of the Internal Revenue Code and Rules 180, 181 and 182[1] of the Tax Court Rules of Practice and Procedure.

Respondent determined a deficiency in petitioner Gail D. Bozek's 1979 Federal income tax of $1,511. Respondent also determined a deficiency in petitioner Lawrence M. Bozek's 1979 Federal income tax of $2,903.13. The issues to be decided are:

(1) whether the income reported by petitioners[2] on their separate returns was community income and, accordingly, properly reportable one-half by each;

(2) whether the deductions claimed by petitioners on their separate returns were community in nature and, accordingly, properly claimed one-half by each;

(3) whether Lawrence M. Bozek is entitled to claim an exemption for Gail D. Bozek;

(4) whether Lawrence M. Bozek or Gail D. Bozek or

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended, and as in effect in the year in issue; all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise indicated.

[2] Petitioner Gail D. Bozek and petitioner Lawrence M. Bozek as a couple will be referred to as the Bozeks or as petitioners. At trial, Gail Bozek went by the name of Gail Canlas. For clarity, we will refer to this petitioner by the name found on her notice of deficiency and petition, i.e. Gail D. Bozek.

either of them is entitled to claim an exemption for their son Justin;

(5) whether Lawrence M. Bozek failed to report $885 in interest income and whether this item of income should be treated as community income;

(6) whether Gail D. Bozek is entitled to additional business, medical and charitable contribution deductions and whether these deductions should be treated as community deductions; and

(7) whether Gail D. Bozek is entitled to have one-half of a tax payment made by Lawrence M. Bozek apply to her tax liability.

To the extent stipulated, the facts are so found. Gail D. Bozek (hereinafter Gail) resided in Arleta, California, at the time she filed her petition. Lawrence M. Bozek (hereinafter Lawrence) resided in La Habra, California, at the time he filed his petition.

During the year in issue, 1979, petitioners were married and lived in the same residence with their minor son, Justin. Lawrence was self-employed as a real estate broker and Gail worked as a saleswoman for M.E. Duncan, Inc.

Lawrence and his mother Veronica Bozek maintained a joint savings account at U.S. Savings and Loan during 1979. The source of the funds deposited into this account was Lawrence's net earnings as a real estate broker. Gail knew that Lawrence was earning money from his real estate business. However, she did not know that Lawrence was depositing his earnings into this account until sometime in March 1979. Whenever a bill had to be paid, Lawrence would withdraw enough money to cover it from the joint account and deposit it in a checking account he maintained with Gail. Veronica made no deposits to, or withdrawals from, this account. The joint savings account earned $885 in interest in 1979, of which $810 was reported as income on the return filed by Veronica Bozek and her husband Joseph Bozek.

Aside from Lawrence's joint account with Veronica, petitioners maintained a joint savings account and two joint checking accounts during 1979.

Petitioners separated in April of 1980 and were divorced one year later. In either May or June of 1980, petitioners sold their family home and received cash of $120,000 for their equity. Neither petitioner brought a significant amount of separate property into their marriage, nor did either receive separate property by way of gift, bequest, devise or descent during their marriage. At the time of separation there was very little, if any, cash left in any of petitioners' accounts, including Lawrence's joint account with his mother.

Petitioners filed separate Federal income tax returns for 1979. Lawrence reported $23,889 in net income from his real estate business (i.e., 100 percent of his net income from his business) and claimed $9,324 of Schedule A deductions. Gail reported $1,968 in wage income, $85 in interest income and $212 in commission income. She claimed no business or Schedule A deductions.

Respondent's position is essentially neutral. He has taken protective positions in the notices of deficiency issued in these consolidated cases. The notice of deficiency addressed to Lawrence leaves the income reported on his return intact, but reduces by one-half the Schedule A deductions shown on his return. The notice of deficiency issued to Gail attributes to her one-half of the income and one-half of the deductions shown on both returns.

In November 1980, Lawrence filed an amended return for the tax year 1979. On this return he reported one-half of the income and one-half of the deductions disclosed on both of the original 1979 returns. The original return filed by Lawrence reported a tax liability of $4,419 while the amended return reported a tax liability of $1,426. A tax payment of $1,732.45 was made by Lawrence on November 12, 1980. The source of the funds used by Lawrence to make this payment was his half of the money derived from the aforementioned sale of petitioners' family home.

For 1979, there was $108 of withholding from Gail's wages, which was refunded in May 1980. In April 1983, one-half of this amount was assessed and applied to Lawrence's tax liability. The notices of deficiency were based upon the original returns.

Preliminarily, a fundamental principle must be noted. The determinations made by respondent in the notices of deficiency are presumed to be correct. Petitioners bear the burden of establishing error in those determinations. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

(1, 2) It has long been held that, as between husband and wife, a State's community property law determines the ownership of income for income tax purposes. United States v. Mitchell, 403 U.S. 190, 197 (1971). Under the community property laws of California, income earned by a spouse during marriage is community income. Cal. Civ. Code sec. 687 (Deering 1971); Winn v. Winn, 143 Cal. App.2d 184, 299 P.2d 721 (1956). Thus, spouses filing separate returns must each report their one-half share of community income. United States v. Malcolm, 282 U.S. 792 (1931). The same is true for deductions. To the extent deductible items are paid out of community funds or relate to community property, they must be claimed one-half by each spouse. Johnson v. Commissioner, 72 T.C. 340 (1979); Clemens v. Commissioner, 8 T.C. 121 (1947).

It is clear that the income earned by petitioners in 1979 while they were still married was community income. Petitioners had no marital or pre-nuptial agreement to the contrary. Petitioners had only a negligible amount of separate property in the form of personal possessions. Hence all of their expenses were paid with community funds and their deductions were community deductions. Accordingly, each petitioner should have reported one-half of the total community income and one-half of the total community deductions on his or her return.

Gail seeks relief from the application of the California community property laws under section 66(c)[3]. Section 66(c) provides as follows:

> (c) Spouse Relieved of Liability in Certain Other Cases. - Under regulations prescribed by the Secretary, if -
>
> (1) an individual does not file a joint return for any taxable year,
>
> (2) such individual does not include in gross income for such taxable year an item of community income properly includible therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse,
>
> (3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and
>
> (4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,
>
> then for purposes of this title, such item of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual).

Although Gail meets the first and second requirements of this section, she fails to meet the third and fourth requirements. Simply stated, Gail knew that Lawrence was earning commissions from his real estate business. The fact that she did not know (until March 1979) that Lawrence was depositing his checks into the joint account with Veronica is not relevant to the test imposed by section 66(c)(3). Furthermore, Gail did not suffer any hardship since Lawrence still applied these funds to community expenses.

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[3] Section 66(c) was added to the Code by sections 424(b)(1) and (c) of the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 802, 803, and applies to all open years.

We believe that Congress did not intend for section 66(c) to apply to facts like those before us since it amended section 66(b) for tax years beginning after 1984. Sec. 424(b)(1), Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 802, 803. Section 66(b) would disallow the benefits of community property law derived by Lawrence if Gail could prove that Lawrence "acted as if solely entitled to such income and failed to notify [Gail]*** of the nature and amount of such income." Sec. 66(b). Although we need not pass on this question, Gail may have found relief under section 66(b) if the tax year in issue had begun after 1984. Accordingly, section 66(c) does not apply to the facts before us. Respondent's determinations on these issues are sustained as to Gail's gross income and deductions and as to Lawrence's deductions. Respondent's determination as to Lawrence's gross income must be decreased by 50 percent.

(3) On his 1979 individual tax return, Lawrence claimed an exemption for Gail. Section 151(b) provides that a spouse not filing a joint return may claim an exemption for the other spouse only if the other spouse has no gross income. See also sec. 1.151-1(b), Income Tax Regs. As Gail earned $1,968 in

wages, $85 in interest and $212 in commissions, Lawrence is not entitled to claim an exemption with respect to her. Respondent is sustained on this issue.

(4) Lawrence also claimed a dependency exemption for petitioners' minor son, Justin. At the trial, Gail likewise asserted a right to this exemption. Section 152(a) requires that a taxpayer must provide a dependent with more than one-half of his support before an exemption may be claimed. Neither Lawrence nor Gail has shown that he or she provided over half of Justin's support for the year at issue, and accordingly, we sustain respondent on this issue.

(5) The joint savings account of Lawrence and Veronica Bozek earned $885 in interest in 1979. Veronica Bozek and her husband reported $810 of this interest income on their 1979 tax return. Lawrence did not report any interest from this account on his 1979 tax return. In the notice of deficiency issued to Lawrence, respondent included $885 in Lawrence's gross income. Respondent has advised the Court that he now concedes the $885 interest income inclusion.

(6) Respondent and Gail stipulated at trial that she is entitled to claim $1,222 Schedule A business deductions in 1979. However, the issue remained whether these deductions were community in nature and, therefore, allocable one-half each to Gail and Lawrence. In accordance with our finding above, and mindful of the fact that petitioners were married throughout all

of 1979, we hold that these additional deductions were for community expenses. Each petitioner will be entitled to claim one-half of $1,222 in additional Schedule A business deductions.

(7) In November 1980, Lawrence submitted a payment on his tax liability of $1,732.45. Gail now seeks to have one-half of this payment applied to her 1979 deficiency. Unfortunately for her, we lack the power to grant her request. As we stated in Perine v. Commissioner, 22 B.T.A. 201, 204 (1931), "[t]he spouses became separate and distinct taxpayers***upon the filing of separate returns of the community income, and the situation is no different than it would be if the taxpayers were other than husband and wife." They being separate taxpayers, we do not have the jurisdictional authority to credit the deficiency determined against Gail with a payment made by Lawrence on his deficiency. Vayssie v. Commissioner, 8 B.T.A. 587 (1927); Crawford v. Commissioner, T.C. Memo. 1961-224.

To reflect the foregoing,

Decision will be entered
under Rule 155.

742-B Ju 11.7/2:1986-38

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T. C. Memo. 1986-38

UNITED STATES TAX COURT

JAMES BURTON, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1298-85. Filed January 28, 1986.

James Burton, pro se.

Jeffrey A. Hatfield, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

AARONS, Special Trial Judge: This case was assigned to Special Trial Judge Aarons pursuant to section 7456(d)(3) and Rules 180, 181 and 182[1].

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended and as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

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ORIGINAL

Respondent determined a deficiency in petitioner's 1982 Federal income tax in the amount of $213. The issues to be decided are: (1) the deductibility under section 162 of petitioner's law school tuition, books and fees, and related transportation expense; (2) the deductibility under section 162 of a subscription to a publication; and (3) the deductibility under section 162 or 170 of dues to a transportation fraternity.

FINDINGS OF FACT

To the extent stipulated the facts are so found. Petitioner resided in Mission Viejo, California at the time he filed his petition.

During 1982 petitioner was employed by American Edwards Laboratories, which is a division of American Hospital Supply Corporation. Petitioner, in 1982 was classified as an Inspector III and in that year was promoted to Assistant Supervisor. His employment was in the critical care apparatus division, which manufactures highly sophisticated electronic devices for diagnostic and other purposes.

For a number of reasons, including the fact that petitioner was required to make decisions affecting company liability and reliability of its products, the employer encouraged petitioner to further his higher education. The employer did not, however, require any particular degree as a condition for promotion. The employer implemented this policy by granting a subsidy to petitioner.

In 1982 petitioner attended Western State University College of Law as a candidate for a Bachelor of Science in Laws (B.S.L.). Under this program the law credits earned by petitioner could subsequently be applied toward a Juris Doctor (J.D.) degree at Western State. The courses taken by petitioner in 1982 in completion of his B.S.L. requirements were the standard first year law school courses, including Contracts, Torts, Property and Criminal Law.

Petitioner in subsequent years entered the J.D. program, and received credit for his 1982 courses. He has attended only night school and therefore is proceeding slowly, but he anticipates receiving a J.D. degree in 1986.

Petitioner had not made up his mind in 1982 whether to pursue a law career.

The claimed deductions in dispute are set forth in the Stipulation of Facts as follows:

Employee Business Expense (Form 2106)	
Law School Related Expense (Tuition, Books Fees)	$5,178.79
Law School Related Expense (Mileage) -4,110 miles at 20¢ per mile	822.00
Professional Portfolios	37.78
Transportation Fraternity (Dues/Fees)	168.00
Other	53.43
Total	$6,200.00[2]

(An adjustment in medical expense deduction turns automatically on the disposition of the above disputed items.)

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[2] The Stipulation of Facts shows the incorrect total of $6,200.00. The correct sum of these expenses is $6,260.00. No explanation was given for this discrepancy.

Petitioner subscribed to a publication of Professional Portfolios issued by the Bureau of Business Practice, and covering such subjects as human relations, personal advancement, communication, and leadership. He paid $37.78 for such subscription.

Petitioner paid dues to Delta Nu Alpha Transportation Fraternity, Inc., in the amount of $168 in 1982. Petitioner conceded that if such dues are deductible at all, it would be under section 170 (charitable contribution) rather than under section 162.

The record contains no proof as to the purpose of the "other" expense in the amount of $53.43. There is no dispute between the parties as to substantiation of any of the disputed items.

OPINION

Petitioner's problem, in attempting to support his law school-related expense deductions, is that he is attempting to apply pre-1967 law (which sanctioned a subjective standard, i.e., intent of the taxpayer in determining the deductibility of education expense). Indeed, the two cases cited to the Court by petitioner, Welsh v. United States, 329 F.2d 145 (6th Cir. 1964), and Campbell v. United States, 250 F. Supp. 941 (E.D. Pa. 1966), are both pre-1967 decisions.

Section 1.162-5(b)(3), Income Tax Regs., as revised in 1967, provides for the disallowance of expenses for education "which is part of a program of study being pursued by [an individual] which will lead to qualifying him in a new trade or business." In Weiler v. Commissioner, 54 T.C. 398, 402 (1970), the Court stated as follows with respect to the applicability of these regulations to a factual situation similar to the instant case (i.e., a revenue agent attending law school):

> The regulations relied on herein, which are the revised regulations relating to educational expenses issued in 1967, have been explained and approved in Ronald F. Weiszmann, 52 T.C. 1106. As noted above, we think the revised regulations set forth an objective standard for the deduction of educational expenses. We have applied that standard and, in doing so, note here that cases involving the deductibility of legal education expenses by revenue agents decided under previous regulations, such as Welsh v. United States,329 F.2d 145; William J. Brennan, T.C. Memo. 1963-243, and Milton L. Schultz, T.C. Memo. 1964-227, are not regarded as having value as precedents.

The Welsh case, mentioned in the above quotation is one of the two cases cited to the Court by petitioner.

The same question (i.e., a school teacher attending law school) was raised in Bodley v. Commissioner, 56 T.C. 1357, 1360 (1971), wherein the Court stated pointedly,"[t]he standards laid down by these regulations are objective ones."

The courses taken by petitioner in 1982 were the classic first year law courses, for which he could receive credit toward a J.D. degree. Under the "objective standard" and as has been held in Weiler, Bodley and many subsequent cases decided by this Court, petitioner's state of mind in 1982 was totally irrevelant. See also Examples (1) and (2), section 1.162-5(b)(3), Income Tax Regs. There cannot be any doubt that petitioner's 1982 courses were objectively part of a program which would qualify petitioner for a new profession. And this is true regardless of the length of time it might take to complete that program, and indeed, regardless of whether in subsequent years such program was in fact completed. Cf. Glenn v. Commissioner, 62 T.C. 270, 278 (1974). We sustain respondent's disallowance of all law school related expense deductions, including tuition, books, fees, and mileage.

With respect to the subscription to the Professional Portfolios, the Court holds that such subscription was proximately related to petitioner's 1982 employment, and is properly deductible under section 162 as an ordinary and necessary business expense. Such deduction is allowable only as an itemized deduction on Schedule A of the return.

As to the Transportation Fraternity dues, petitioner has conceded the nondeductibility under section 162. The incomplete constitution of Delta Nu Alpha Transportation Fraternity, Inc., and the By-laws of the Golden West College Chapter, in evidence herein, are inadequate to prove that the organization was both organized and operated exclusively for charitable (including educational) purposes, as defined in section 170(c). However, the Court stated at the trial that the deduction would be allowed if the fraternity is listed as a tax-exempt organization by the Internal Revenue Service. Delta Nu Alpha Transportation Fraternity, Inc., Golden West College Chapter, was not listed in 1982 as a tax-exempt organization by the Service. Cumulative List of Organizations Described in Section 170(c) of the Internal

Revenue Code of 1954, Internal Revenue Service Publication 78 (Rev. 1-31-83). Hence, we sustain respondent's disallowance of this item.

We likewise sustain respondent's disallowance of the $53.43 deduction for "Other", in the absence of any proof of the nature of this item. Rule 142(a).

To reflect the foregoing,

Decision will be entered under Rule 155.

0142-B Ju 11.7/2:1986-39

COMPLETED

T. C. Memo. 1986-39

UNITED STATES TAX COURT

ROBERT N. FAILLA AND ANN MARIE FAILLA, Petitioners *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

ANN MARIE FAILLA TRUST, ANN MARIE FAILLA, TRUSTEE, Petitioner
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 29077-83, 29078-83. Filed January 29, 1986.

Samuel N. Reikin, for the petitioners.

William F. Halley, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KÖRNER, *Judge*: In these consolidated cases, respondent determined deficiencies in Federal income tax against petitioners as follows:

Petitioner	Taxable year ended	Deficiency
Robert N. Failla and Ann Marie Failla Docket No. 29077-83	12/31/78	$269,020
Ann Marie Failla Trust, Ann Marie Failla Trustee Docket No. 29078-83	3/31/79 3/31/80 3/31/81	1,624 24,744 27,325

After concessions in docket No. 29077-83, the issue presented for decision is whether the sale by Robert N. Failla of his Aero Gear Machine and Tool Corporation stock to the Ann Marie Failla Trust should be regarded as a bona fide installment sale for purposes of section 453.[1]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Robert N. Failla ("Robert" or "petitioner") and Ann Marie Failla ("Ann Marie") were husband and wife and residents of Short Hills, New Jersey, at the time their petition was filed. Robert and Ann Marie timely filed joint Federal income tax returns for their taxable years 1978, 1979, and 1980. Ann Marie, as trustee of the Ann Marie Failla Trust, timely filed Forms 1041, Fiduciary Income Tax Returns, for the Trust's taxable years ended March 31, 1979, March 31, 1980, and March 31, 1981.

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[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

Aero Gear Machine and Tool Corporation ("Aero Gear") was a New Jersey corporation organized in 1955. Aero Gear was engaged in the manufacture of aerospace gears used in helicopter transmissions, accessory gear boxes for commercial aircraft engines, and gas turbine gear boxes for gas compression, electrical generation, and fluid flow. Petitioner joined Aero Gear in 1973, and became a shareholder some three or four years later. For more than two years prior to April 14, 1978, Aero Gear's sole shareholders were petitioner, who owned 44 of the outstanding 100 shares, and William Spitz ("Spitz"), who owned 56 shares. Aero Gear never paid any dividends to its shareholders.

In late 1976, Robert was contacted by William Vandersteel, a representative of Ampower, a New Jersey corporation and the American representative of Lohmann and Stuldtfutt ("L&S"). L&S was a member of the Mannesmann group, a West German conglomerate. Vandersteel stated that L&S was a distributor of gear units interested in the acquisition of a gear manufacturing company in the United States. Robert stated that he and Spitz were interested in such an arrangement.

Representatives of L&S visited Aero Gear twice in 1977 to survey the facilities and review the corporation's financial statements. After doing this, they stated that they would consider Aero Gear as a potential acquisition. In August 1977, Robert and Spitz traveled to Germany, where they met with representatives of G.L. Rexroth GmbH ("Rexroth"), another wholly owned subsidiary of Mannesmann, and discussed the possibility of Rexroth's acquisition of Aero Gear. The results of the meeting were set forth in a document entitled "Main points of agreement between Messrs. Spitz and Failla * * * and G.L. Rexroth GmbH * * *," dated August 12, 1977. The document provided, in pertinent part, as follows:

> 1. The sellers sell 100% of the shares of the Aerogear Corporation (afterwards called "the Company"), Little Ferry, to the buyer, provided, that the Board of the buyer resp. the Mannesmann AG give their approval to this acquisition.
>
> 2. As selling price of the shares the buyer shall pay $2.750.000, -- to the sellers after signing the final contract.
>
> * * *
>
> 3. The sellers shall as managers of the Company receive a salary of $50.000, -- per year, each.
>
> * * *
>
> 6. The search for land and qualified employees for the designing department shall start immediately after the approval of the acquisition by the Mannesmann AG.
>
> * * *

The document was signed by Spitz, Robert, and the representatives of Rexroth. Petitioner and Spitz agreed to furnish Rexroth's representatives with additional financial data, a detailed list of Aero Gear's customers, the extent and nature of Aero Gear's present and future business with the said customers, and information concerning the anticipated needs and approximate cost of manufacturing equipment should an acquisition take place.

A memorandum entitled "Main points of contract concerning Aero Gear Corp.," dated March 10, 1978, and prepared by Rexroth recites, in pertinent part:

> 1) G.L. Rexroth forms a new company "American Lohmann Corp." or similar in the next weeks.
>
> 2) This new company buys the assets and assumes the liabilities from Aero Gear resp. from the shareholders of Aero Gear.
>
> For that is necessary an actual list of all assets (fixed assets, stocks, debtors etc.) and all liabilities up to the actual date of purchase, f.i. April 1st.
>
> These assets must be revaluated with the actual value at the date of purchase. The balance (assets minus liabilities) coming out is \$2.750.000, --. The assets should include a goodwill for taking over the whole business of \$200.000, --.
>
> 3) Payment by G.L. Rexroth the new company (A-L) is made as follows:
>
> 70% after closing of the contract
> 30% at Sept. 30th 1979, if Mr. Spitz and Mr. Failla are still working for the company
>
> * * *
>
> 6) Perhaps the question of profit of Aero Gear for the period Jan. 1st to March 31st 1978 is raised by Mannesmann, because the first intention was, to purchase the company retrospective on Jan. 1st 1978. Eventually this question has to be discussed.

7) The promised bonus to the sellers is $750.000, --, which amount is to be paid under certain conditions in 1982 will be settled in the employment contracts of Mr. Spitz and Mr. Failla.

* * *

In early March 1978, Rexroth retained Harold Berger, a Philadelphia, Pa., attorney, as its counsel in the negotiations with Aero Gear. Aero Gear thereupon retained William D. Lipkind, a West Orange, New Jersey, attorney, as its counsel.

On March 20, 1978, Rexroth sent a telex letter to Berger and instructed him to deal with the Aero Gear matter and to revise (1) the agreement between Aero Gear and American Lohmann Corporation ("Lohmann") for the purchase of the assets of Aero Gear, (2) the employment contracts of Spitz and Robert with Lohmann, (3) the lease contracts between Aero Gear and Lohmann with respect to the land and buildings, located in Little Ferry and Hillside, New Jersey, owned by Spitz and petitioner, and (4) Lohmann's by-laws. The telex provided, in pertinent part, as follows:

* * *

> our schedule is as follows:
>
> 1. mid april 78 signing of the contracts acc. to paragraph 1, presumably on 14.4.78.
> 2. 1.5.78 taking over the assets.
>
> the new company american lohmann corporation should be incorporated before mid april. at the same time the contracts as to paragraph 1 should also be "ready for signature." in concrete this means:

> - week commencing 20th march . . . preparing of contracts by yourself and mr. max s. mayer
> - week commencing 27th march . . . presentation of contracts to mr. spitz and mr. failla, so that they have the possibility to discuss the same with their consultants.
> - week commencing 3rd april . . . execution - necessary contract modifications and final discussion between both parties, resp. their consultants.

* * *

Spitz was provided with a copy of the aforementioned telex.

In late March 1978, Robert and Ann Marie met with Lipkind to discuss the potential consequences of the proposed sale of the assets of Aero Gear and its subsequent liquidation. Ann Marie expressed her concern that upon the sale and subsequent liquidation of Aero Gear, Robert was to receive a substantial amount of money. Given the fact that Robert had been involved in a Chapter 11 bankruptcy proceeding in 1972, in connection with his involvement with another company, Ann Marie doubted his ability to manage money. Ann Marie wanted to safeguard any proceeds to be received from the said sale and subsequent liquidation and believed that she owned half of Robert's stock.

Ann Marie was informed by Lipkind that she had no direct right to Robert's shares except, probably, by way of equitable distribution, upon divorce. Lipkind suggested an installment sale of Robert's stock to a trust as a means of protecting the money; Ann Marie and her children would be the beneficiaries of the said trust. Lipkind discussed the "Rushing Trust," and the then existing case law. Lipkind further informed Robert and Ann Marie that if the trust was created, the sale of the stock of Aero Gear by Robert to the trust had to be made in all events, regardless of whether the transaction with the Mannesmann group was consummated. Robert and Ann Marie were also apprised of the risk of making an installment sale of the stock to the trust and having the proposed sale not occur, viz, that the trust would have to come up with money in accordance with the terms of the sale.

With reference to the identity of the trustee of the proposed trust, Lipkind recommended that a bank be appointed trustee in order to avoid potential problems with the Internal Revenue Service. Ann Marie stated her belief that she was qualified to administer the trust as ably as any bank, and without having to pay any fees. Ann Marie's belief was based on her experience in handling the household finances and her work, as a volunteer, with the Garden State Ballet Foundation, the New Jersey Society to Prevent Blindness, the Parish Council of St. Rose of Lima, the Paper Mill Playhouse Renovation Committee, and the Deanery Council of the Archdiocese of Newark. Ann Marie has a Bachelor of Arts degree in English, Journalism, and History from St. Joseph's College in Maryland. She is a self-confident and assertive woman.

The tax consequences of the creation of the trust were also discussed at the meeting between Robert, Ann Marie, and Lipkind. It was concluded that Lipkind would proceed with the preparation of the documents necessary for the creation of the trust.

On April 3, 1978, Rexroth formed Lohmann, as its wholly owned subsidiary.

On April 7, 1978, pursuant to a trust agreement between Lipkind, as grantor, and Ann Marie Failla, as trustee, the Ann Marie Failla Trust (the "Trust") was created.

The trust agreement provided that should Ann Marie die, resign, be disqualified, or cease to act as trustee for any reason, Ann Marie's friend, Albert Shea, was to serve as trustee in her place, subject to Robert's right to appoint a co-trustee. The Trust was established with the transfer of $10. The beneficiaries of the Trust were Ann Marie and her children. At the time of the creation of the Trust, Ann Marie had a minor son and daughter, both of whom were also Robert's children.

The trust agreement provided, inter alia, that until Robert's death, if there was another trustee other than, or in addition to, Ann Marie, that trustee had the power to, in his sole and unreviewable discretion, pay or apply to or for the benefit of Ann Marie and/or her children, equally or unequally, any of the net income and/or principal of the Trust. The trust agreement further provided that, if in the exercise of his discretion, the trustee paid or applied all of the net income and principal of the Trust, the agreement, and all trusts created thereunder, would terminate.

Robert had the power, under the trust agreement, to designate any individual, other than himself, or a corporate banking institution to serve as a co-trustee. At no time during Robert's lifetime were more than two trustees to be serving. Robert could remove any trustee except Ann Marie. The said right of removal was exercisable by Robert only five times during his lifetime.

Except as provided with respect to Robert's power to appoint a co-trustee, the Trust created under the trust agreement was to terminate 21 years after the death of the last survivor of Ann Marie, Robert, and Ann Marie's children living at the date of execution of the agreement.

The trust agreement granted very broad administrative powers over the Trust's property and the investment of the principal and interest to the trustee. Such powers were exercisable by her at such times and manner, and in accordance with such criteria, as she, in her sole discretion, deemed appropriate.

By deed dated April 10, 1978, Robert and Ann Marie sold property located at 1470 Chestnut Avenue, Hillside, New Jersey (the "Chestnut Avenue property"), to Ann Marie, as trustee of the Trust, for a stated consideration of $125,300, paid with a six-percent mortgage note to be paid in installments of $2,070.73, on the first day of every third month, beginning on July 1, 1978 through July 1, 1998.

On April 13, 1978, Robert and Ann Marie filed an Affidavit of Consideration or Exemption with the Register of Deeds or County Clerk of Union County, New Jersey, claiming that the deed transfer of the Chestnut Avenue property to the Trust was exempt from any realty transfer fees.

The Chestnut Avenue property was rental property. Ann Marie, as trustee of the Trust, reported gross rentals of $13,260 for each of the taxable years ending March 31, 1979, March 31, 1980, and March 31, 1981, and deductions (other than interest and depreciation) in the respective amounts of $6,282, $7,095, and $5,634.

On April 14, 1978, Robert sold his 44 shares of Aero Gear to Ann Marie, as trustee of the Trust for a stated consideration of $880,000. Robert had a basis of $26,572 in his Aero Gear stock. For the period beginning on April 14, 1978, and ending on December 31, 1978, interest only, at the annual rate of six percent on the unpaid balance, was to be paid on January 1, 1979. The unpaid balance of the purchase price was to be paid in 80 equal quarterly installments of principal and interest, at an annual rate of six percent, beginning on January 1, 1979.

Payments were to be made as reflected on Schedule A attached to the sales agreement. Schedule A provided for 80 quarterly payments of $18,962.52 each.

The sales agreement provided that, as collateral security for the prompt payment, when due, of all the obligations of the Trust to Robert under the agreement, the Trust granted a security interest in the Aero Gear stock to Robert. The agreement further provided that unless an event of default occurred in the payment of the installments, the purchaser would be entitled to receive any dividends and/or distributions, except such as may be received in the form of stock. The sales agreement further stated that:

* * *

> The Stockholder has been advised of the fact that the Purchaser intends to cause the Corporation to adopt a Plan of Liquidation pursuant to the provisions of Section 331 of the Internal Revenue Code of 1954, as amended. The Purchaser may so liquidate the Corporation and surrender the Corporation Stock for cancellation. Upon distribution of the assets of the Corporation, the Purchaser will grant to the Stockholder a security interest in the assets so distributed, in order to secure the then remaining balance of the purchase price. The Purchaser shall execute any and all documents which counsel for the Stockholder deems reasonably necessary for the creation of such security interest.

* * *

Ann Marie was never an officer, director, or employee of Aero Gear. She never had any investment or financial interest in Aero Gear prior to the purchase of Aero Gear stock by the Trust, nor did she take an active part in the affairs of Aero Gear. Ann Marie never actively engaged in any of the negotiations for the sale of the assets of Aero Gear.

Stock certificate no. 15, for 44 shares of Aero Gear, was issued to Ann Marie, as trustee of the Trust, on April 14, 1978.

On April 14, 1978, a trust was established by and between William Spitz and Doris Spitz, as grantors, and Herbert Zarrow, C.P.A., Raymond Zarrow, C.P.A., and Marvin Klein, C.P.A., as trustees (the "Spitz Trust"). Each of the trustees was an independent certified accountant, unrelated by blood or marriage to the grantors, and had never been an employee of a corporation in which either of the grantors held a significant interest or in which one of the grantors was an executive. The sole beneficiaries of the Spitz Trust were the grantor's issue and their spouses. On April 14, 1978, Spitz sold his 56 shares of Aero Gear stock to the Spitz Trust.

On April 14, 1978, the shareholders and directors of Aero Gear adopted a plan of complete liquidation pursuant to sections 331 and 337. A consent, in lieu of a special joint meeting of the directors and shareholders of Aero Gear, was signed by

Herbert Zarrow, Raymond Zarrow, and Marvin Klein, as trustees-shareholders of the Spitz Trust, Doris Spitz, and Robert, as directors, and Ann Marie, as trustee of the Trust. Form 966, Corporate Dissolution or Liquidation, was signed by William Spitz, as president of Aero Gear, and filed with the Internal Revenue Service on April 14, 1978.

On April 17, 1978, Berger sent drafts of the employment agreements for Spitz and petitioner and the acquisition agreement to Lipkind. These were the first drafts exchanged between the parties in connection with the sale of the assets of Aero Gear to Lohmann. Five other drafts of the acquisition agreement, dated May 3, 1978, June 3, 1978, and June 28, 1978, respectively, and of the guaranty agreement, dated May 8, 1978, were exchanged by counsel to the parties.

On June 30, 1978, the directors and shareholders of Aero Gear, including Ann Marie, as trustee of the Trust, executed an "Unanimous consent of directors and shareholders in lieu of a special joint meeting of the directors and shareholders of Aero Gear Machine & Tool Corporation," approving the sale of the assets of Aero Gear to Lohmann.

On July 5, 1978, all of the assets of Aero Gear were sold to Lohmann. At the closing, held in Germany, the following documents were signed and executed: (1) Sales agreement; (2) Spitz employment agreement; (3) Failla employment agreement; (4) Lease for premises located at 1409 Chestnut Avenue, Hillside, New

Jersey; (5) Lease for premises located at 74 Industrial Avenue, Little Ferry, New Jersey; (6) Guarantee of Rexroth; and (7) Bill of sale: Assignment and Assumption Agreement.

Pursuant to the terms of the employment agreement between Lohmann and petitioner, petitioner was to be employed as vice president of Lohmann for at least five years at an annual salary of $50,000, plus additional compensation based on its pre-tax corporate earnings.

In compliance with the provisions of the acquisition agreement, Lohmann paid $1,925,000 in cash to Aero Gear[2] on July 5, 1978. The balance of the total purchase price of $2,750,000, or $825,000, was due to be paid on December 15, 1979. On July 21, 1978, the Trust received a distribution, in the amount of $440,000, from Aero Gear. This was the only distribution of funds to the Trust from Aero Gear during 1978.

On March 6, 1979, Aero Gear was formally liquidated pursuant to a Bill of Sale. All of the assets of Aero Gear were distributed to the Spitz Trust and the Trust according to their respective stockholdings, viz, 56 percent and 44 percent. The Trust received cash and contract receivables of $485,750 over and above the $440,000 distributed in 1978. The shareholders of Aero Gear -- the Spitz Trust and the Trust -- thereupon filed a

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[2] On July 5, 1978, the certificate of incorporation of Aero Gear was amended and the name of the corporation was changed to "Spitz-Failia Corp." For clarity, however, we will continue to refer to the corporation as Aero Gear.

"Certificate of dissolution by unanimous consent of all the shareholders of Spitz-Failla Corp." with the Secretary of State of the State of New Jersey.

Ann Marie, as trustee of the Trust, invested a substantial portion of the proceeds of the July 21, 1978 and March 6, 1979 liquidation distributions in certificates of deposit and U.S. treasury bills. In so doing, Ann Marie had the assistance and advice of Louis Brisgel, an investment counselor with Shearson-American Express in Short Hills, New Jersey. Brisgel referred Ann Marie to Leslie Pollack, the chairman of Shearson Management Incorporated in New York City. Ann Marie gave approximately $180,000 of the Trust's money to Pollack, to be invested in high quality common stock. Ann Marie felt that she could handle the certificates of deposit and treasury bills, but needed the guidance of a person such as Pollack in investing in the stock market.

The current assets of the Trust were invested as follows as of the following dates:

	3/31/80	3/31/81	3/31/82	3/31/83
Cash	$ 276	$ 1,040	$ 991	$ 466
Certificates of Deposit	100,000	104,000	113,755	602,922
Treasury Bills	644,308	543,647	539,213	-
Shearson Daily Dividend, Inc.	2,068	27,145	9,591	31,404
Marketable Securities & Stock	81,905	183,798	166,495	163,278
Mortgage Receivable	-	46,784	42,364	37,234
Other	-	6,075	6,489	1,322
Receivable from Lohmann	44,000	-	-	-
Total	$872,557	$912,489	$878,898	$836,626

The mortgage receivable shown, supra, represents a $50,000 mortgage loan, at an annual rate of interest of 14 percent, given to Spitz and Robert on a building owned by them. Other than the said mortgage loan, the Trust did not make any loans to Robert or to any business firm or entity in which Robert had an interest.

On June 7, 1980, Robert N. Failla executed a waiver of the rights and powers granted to him, pursuant to the Trust agreement dated April 7, 1978, to remove any trustee other than Ann Marie. On January 23, 1981, Robert appointed Herbert Zarrow, his friend and accountant, as co-trustee of the Trust. As a result of the waiver of June 7, 1980, Robert is without the right to remove Herbert Zarrow as co-trustee. Zarrow authorized non-required distributions to the Failla children in 1981.

On their joint Federal income tax return for the taxable year ended December 31, 1978, Robert and Ann Marie reported the sale of the stock of Aero Gear by Robert to Ann Marie, as trustee of the Trust, on the installment basis.[3] Robert and Ann Marie reported gain, in the respective amounts of $17,022 and $23,911

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[3] Robert and Ann Marie realized a gross profit on the sale of the Aero Gear stock, as follows:

Sales Price	$880,000
Basis	(26,572)
Gross Profit	$853,428

The gross profit ratio was .97; no taxable gain was reported for 1978, because no principal payments were made to them by the trust in that year.

for their taxable years 1979 and 1980.[4] Robert and Ann Marie reported interest income from the installment sale of the Aero Gear stock of $3,756, $39,339, and $51,199 for their taxable years 1978, 1979, and 1980, respectively.

Ann Marie, as trustee of the Trust, reported a short-term capital gain from the liquidation of Aero Gear in the amount of $45,750,[5] for the taxable year ended March 31, 1979, and took interest deductions, for interest paid on the Aero Gear installment sale obligations, in the respective amounts of $50,600, $51,923, and $50,454 for the taxable years ended March 31, 1979, March 31, 1980, and March 31, 1981.

In his statutory notices of deficiency, respondent charged Robert with a long-term capital gain from the distributions in liquidation of Aero Gear in the amount of $899,178 for 1978,[6] and eliminated the reported interest income for years 1978, 1979, and 1980. Respondent also disallowed the Trust's claimed

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[4] Based upon principal payments received of $17,548 and $24,651.

[5] Computed as follows:

Amount received in liquidation	$ 925,750
Basis in Aero Gear Stock	(880,000)
Gain	$ 45,750

[6] Computed as follows:

Liquidation distribution	$925,750
Basis in Aero Gear stock	(26,572)
Long-term capital gain	$899,178

interest deductions relating to the Aero Gear stock installment sale obligation and eliminated the reported short-term capital gain from the liquidation of Aero Gear.

OPINION

This case presents still another application of the "substance-over-form" theory. Simply stated, the issue presented is whether the form in which a transaction is cast should be determinative of its tax results, or whether, on the other hand, the formalities in which the transaction was clothed should be ignored and tax treatment accorded pursuant to the actual economic substance.

Respondent contends that the installment sale of Aero Gear stock by Robert to the Trust lacked economic reality and substance, was not a bona fide installment sale for purposes of section 453, and should be ignored for tax purposes.7/

Petitioners, predictably, argue otherwise.

7/ On brief, respondent contends that Robert had long-term capital gains as follows:

	1978	1979
Liquidation Distribution		
Amount received on July 5, 1978	$440,000	
Amount received on March 6, 1979		$485,750
Basis in stock	(26,572)	0
Long-term capital gain	$413,428	$485,750

We note that such position is contrary to respondent's determination in his statutory notice to Robert and Ann Marie, and that respondent did not issue a notice of deficiency to Robert and Ann Marie for their taxable year 1979. Given our disposition of the case, no further comment is necessary.

Section 453 permits taxpayers to report the income from the sale or other disposition of certain property on the installment method.8/ In Commissioner v. South Texas Lumber Co., 333 U.S. 496, 503 (1948), the Supreme Court described the installment method as a modified cash receipts basis, enacted "to relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the

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8/ Sec. 453 provided, in pertinent part, as follows during the years in issue:

> Sec. 453. INSTALLMENT METHOD.
>
> (b) Sales of Realty and Casual Sales of Personalty.--
>
> (1) General Rule.--Income from--
>
> (A) a sale or other disposition of real property, or
>
> (B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000,
>
> may (under regulations prescribed by the Secretary) be returned on the basis and in the manner prescribed in subsection(a).
>
> (2) Limitation.--Paragraph (1) shall apply only if in the taxable year of the sale or other disposition--
>
> (A) there are no payments, or
>
> (B) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

sales price." Another reason for the enactment of section 453 was the difficult and time-consuming effort of appraising the uncertain market value of the installment obligations. Commissioner v. South Texas Lumber Co., supra at 503; Vaughn v. Commissioner, 81 T.C. 893, 907 (1983). Section 453 "spreads the taxpayer's profit on the sale over the collections by requiring the payments actually received to be included in income in the proportion that the anticipated gross profit on the sale bears to the contract price." Bittker, Federal Taxation of Income, Estates and Gifts, Vol. 4, par. 106.2.1, pp. 106-2 -- 106-3 (1981 ed.)

Since section 453 is an exception to the general rule that the entire amount of gain from the sale or other disposition of property is taxed to the seller in the year of the sale, it is to be construed narrowly. Vaughn v. Commissioner, supra at 907-908; Pozzi v. Commissioner, 49 T.C. 119, 127 (1967). Section 453 is inapplicable where the taxpayer has entered into an arrangement which is in form but not in substance a true installment sale. Griffiths v. Helvering, 308 U.S. 355 (1939); Lustgarten v. Commissioner, 639 F.2d 1208, 1210 (5th Cir. 1981), affg. per curiam 71 T.C. 303 (1978); Williams v. United States, 219 F.2d 523 (5th Cir. 1955).

The fact that one of the motives underlying the questioned transaction was a desire to save taxes, even though such motive was a major motive, however, will not prevent the transaction from being recognized for tax purposes. United States v. Cumberland Public Service Co., 338 U.S. 451 (1950); Commissioner v. Court Holding Company, 324 U.S. 331 (1945). The Supreme Court stated in Gregory v. Helvering, 293 U.S. 465, 469 (1935):

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted * * *. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. [Citations omitted.]

As we said in Fink v. Commissioner, T.C. Memo. 1982-284:

> Thus, the question is not whether a tax saving motive was present in structuring the transaction in question, or even whether such tax motive may have been a highly important reason for doing so; rather, the question is whether the transaction had any business reasons or economic reality aside from the tax motives -- in other words, whether what purported to happen really did happen, or whether it was a purely ephemeral shuffling of papers, having no substance or reality beyond a desire to avoid taxes.

It must also be noted that each case must be considered upon its own facts and in light of all the relevant surrounding circumstances. Bowen v. Commissioner, 78 T.C. 55 (1982), affd. per curiam 706 F.2d 1087 (11th Cir. 1983)

In Rushing v. Commissioner, 52 T.C. 888 (1969), affd. 441 F.2d 593 (5th Cir. 1971), two taxpayers each owned 50 percent of the stock of two corporations. The taxpayers as directors agreed to dispose of all of the corporations' assets by liquidating them pursuant to section 337. Both corporations sold substantially all of their assets within the 12-month period following adoption of their plans of liquidation for cash and notes. Shortly before the expiration of the 12-month liquidation period, each of the taxpayers created irrevocable trusts for each of his children. The trusts were funded with a total of 50 shares of stock of another corporation, as a gift, with a total value of $46,784.08. A bank was appointed as trustee. While the taxpayers retained the right to remove the trustee, only a bank in which the taxpayers had no significant interest could be appointed as a replacement trustee. Five days after the creation of the trusts, the taxpayers sold their shares of stock in the liquidating corporations to the trustee for a total price of $625,000. The trustee purchased the stock by paying part cash ($7,000) and executing notes for the remainder ($618,000), payable to the taxpayers over a period of years. The notes provided for the payment of interest, at the rate of 5 percent annually, and were secured by the general assets of the trusts. In each case the total purchase price payable by the trusts was an amount approximate to the anticipated liquidation distribution to be paid shortly thereafter on the stock purchased.[9] Within the

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[9] Both corporations transferred in liquidation all assets and liabilities to the trustee as sole shareholder. The main assets of one of the corporations was a note in the principal amount of $325,456.50 and an account receivable of $75,931.12. The main asset of the other corporation was a note in the approximate amount of $322,875. The total is $724,262.62. See *Rushing v.*

(footnote continued)

12-month statutory period, the trustee, as sole shareholder, and the taxpayers, as officers and directors of the two corporations authorized the distributions in liquidation of the assets of the corporations. The trustee collected the liquidation proceeds. The Commissioner determined that the taxpayers were not entitled to the benefits of the installment method of reporting gain, based on the contention that the taxpayers constructively received the corporate assets in liquidating distributions and sold such assets, rather than their stock, to the trusts, and assessed deficiencies for the tax on the difference between the proceeds received in liquidation and their basis in the stock.

In affirming our holding -- that the taxpayers were entitled to report the gain from the sale of their stock to the trusts under the installment method in section 453[10] -- the Court of

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(footnote continued from previous page)
Commissioner, 52 T.C. 888, 892-893 (1969), affd. 441 F.2d 593 (5th Cir. 1971).

[10] Sec. 453 was amended by sec. 2(a) of the Installment Sales Revision Act of 1980, Pub. L. 96-471, 94 Stat. 2247, with respect to dispositions of property made after May 14, 1980, to provide that when a person disposes of property to a related person, as defined in sec. 318(a) (other than paragraph 4 thereof), and before the person making the first disposition receives all payments with respect to such disposition the related person disposes of the property, then the amount realized with respect to the disposition of the property by the related person shall be treated as having been received by the person who disposed of the property to the related person. We are not concerned in this case with whether the facts here would fall within the provisions of the amendment since the committee reports specifically provide that "[t]he committee intends that no inference be drawn from these provisions as to the proper treatment of any related party installment sale occurring prior to the effective date provided
(footnote continued)

Appeals for the Fifth Circuit stated:

> This is not the first time that a taxpayer, in order to receive installment sale benefits, has created a third entity between himself and the ultimate source of his profit. *See e.g.*, *Griffiths v. Helvering*, 1939, 308 U.S. 355, 60 S.Ct. 277, 84 L.Ed. 319; *Hindes v. United States*, 5 Cir. 1967, 371 F.2d 650 [cert. denied 386 U.S. 992 (1967)]; *Hindes v. United States*, 5 Cir. 1964, 326 F.2d 150 [cert. denied 377 U.S. 908 (1964)]; *Williams v. United States*, 5 Cir. 1955, 219 F.2d 523; *Pozzi v. Commissioner of Internal Revenue*, 1967, 49 T.C. 119. We think it clear from a reading of these cases that a taxpayer may, if he chooses, reap the tax advantages of the installment sales provision if he actually carries through an installment sale, even though this method was used at his insistence and was designed for the purpose of minimizing his tax. *Williams v. United States*, *supra*, 219 F.2d at 527; *Pozzi v. Commissioner of Internal Revenue*, *supra*, 49 T.C. at 128. On the other hand, a taxpayer certainly may not receive the benefits of the installment sales provisions if, through his machinations, he achieves in reality the same result as if he had immediately collected the full sales price, or, in our case, the full liquidation proceeds. As we understand the test, in order to receive the installment sale benefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom. * * * [441 F.2d at 597-598]

Under this test, the trusts were held to be autonomous entities not controlled by the selling taxpayers, who retained no effective benefit or control over the liquidation dividend.

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under the bill." H. Rept. 96-1042 to accompany H. R. 6883 (Pub. L. 96-471, 94 Stat. 2247)(1980); S. Rept. 96-1000, at 17 (1980), 1980-2 C.B. 494, 503. The amendment of sec. 453 by sec. 403(d)(4)(B) of the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, 94 Stat. 229, 305, is also inapplicable to the facts herein.

The Rushing case has been followed by this and other courts in later cases where similar factual situations were presented. See e.g., Weaver v. Commissioner, 71 T.C. 443 (1978), affd. 647 F.2d 690 (6th Cir. 1981); Pityo v. Commissioner, 70 T.C. 225 (1978); Roberts v. Commissioner, 71 T.C. 311 (1978), affd. 643 F.2d 654 (9th Cir. 1981); Nye v. United States, 407 F.Supp. 1345 (M.D. N.C. 1975).[11]

In cases where it was shown that the seller under the installment contract (1) had effective control over the buyer viz, the buyer was acting as an agent of the original seller in reselling the property, or (2) the seller reserved to himself significant rights with respect to the proceeds of the buyer's later sale, e.g., where there is an escrow agreement,[12] the courts have tended to find that the installment sale was a mere sham transaction, lacking economic reality and have held that the installment sale was to be disregarded for income tax purposes. See Griffith v. Commissioner, 73 T.C. 933 (1980); Lustgarten v.

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[11] See also Davidson v. Commissioner, T.C. Memo. 1981-467; Wilson v. Commissioner, T.C. Memo. 1980-288.

[12] The payment of funds by a purchaser into an escrow account results in the constructive receipt of such funds by the seller if (1) the funds are not subject to substantial conditions or limitations other than time of payment, and (2) the seller expects to collect from the funds placed in escrow. Griffith v. Commissioner, 73 T.C. 933, 943 (1980); Oden v. Commissioner, 56 T.C. 569 (1971).

Commissioner, supra; Trivett v. Commissioner, T.C. Memo. 1977-161, affd. 611 F.2d 655 (6th Cir. 1979); Wrenn v. Commissioner, 67 T.C. 576 (1976); Pozzi v. Commissioner, supra.

In Wrenn v. Commissioner, supra, the wife bought stock belonging to her husband on the installment basis for a total price of $250,000, plus interest at an annual rate of 5 percent, payable in installments over a 15-year period and resold them on the open market on the same day for $250,874. Under the terms of the installment sales contract, the wife agreed to provide her husband with a security for the payment of the agreed price by purchasing $250,000 in shares of the Fidelity Trend Fund, which she did. We upheld the Commissioner's disallowance of the installment provisions and found that the installment sale was not bona fide in nature because neither husband nor wife had any independent purpose of a business or personal nature, other than tax avoidance, for entering into the sale. Thus, this Court added an independent purpose requirement to the test articulated in Rushing v. Commissioner, supra, in judging intrafamily installment sales.

Applying all these principles to the facts of the instant case, we conclude that petitioners have the better of the argument, that the transaction herein at issue was bona fide, and that Robert is entitled to report his gain from the sale of his Aero Gear stock under the installment method.

Respondent contends that Robert and Ann Marie are not independent, autonomous entities. Respondent concedes that Ann Marie "has been shown to be an intelligent and resourceful person," but argues that "she had never before taken an interest in Aero Gear and had never before invested any money in her own name, [and that there] is no evidence that she ever engaged in any profit seeking venture in her life."

In testing the reality of sales transactions, sales between family members are scrutinized with greater skepticism than sales between unrelated parties. Vaughn v. Commissioner, 81 T.C. at 908; Bowen v. Commissioner, 78 T.C. at 78; Wrenn v. Commissioner, 67 T.C. at 584. "This is because of the greater potential for complicity between related parties in arranging their affairs in a manner devoid of legitimate motivations." Bowen v. Commissioner, 78 T.C. at 78.

The cases which have applied the Rushing rationale have focused on the independence of the trustee of the trust to which the sale was made in determining whether the taxpayer had continuing control over the proceeds from the sale or, in our case, liquidation. See Pityo v. Commissioner, supra; Roberts v. Commissioner, supra.

In Goodman v. Commissioner, 74 T.C. 684 (1980), two taxpayers owned an apartment building. The taxpayers were the trustees of trusts created by the father-in-law of one of them and the mother of the other for the benefit of the grantors' grandchildren (the taxpayers' children). The trustees were given great discretion in their decisions on investments and distributions. The taxpayers entered into a contract to sell the apartment building to the trust on the installment basis. On the next day the taxpayers, as trustees of the trust, entered into a contract for the sale of the apartments to a third party. The sale to the trusts was closed in accordance with the contract for sale and purchase. A promissory note and mortgage, which was not recorded, were given by the trusts to the taxpayers as security for the payment of the unpaid balance of the purchase price. The sale to the third party was consummated on the next day. The taxpayers elected to report their gain on the sale of the apartment building to the trusts on the installment basis. We noted that, in making the sale, the taxpayers acted in the best interest of the trusts, that they did not have control over the proceeds of the sale or control over making the sale to the third party except in their capacity as trustees, which was a capacity distinct and apart from their capacity as individual sellers of the property, and upheld the taxpayers' use of the installment method.

We think that the facts herein are even stronger for petitioners than those in Goodman. Respondent contends that Goodman was wrongly decided and invites us to reconsider our holding in that case. We decline his invitation. We are satisfied that in buying the Aero Gear stock from Robert, and selling it to Lohmann, Ann Marie, as trustee of the Trust, was acting in the best interests of the Trust, and of herself and her children, as beneficiaries. Concededly, Ann Marie held no outside employment and was economically dependent on her husband for her support during the years in issue. However, this is not determinative. Ann Marie impressed us as a self-confident and assertive woman. On the record before us, we are satisfied that the Trust had the complete and unfettered legal right and ability to dispose of the Aero Gear stock as it deemed proper, and that Ann Marie was neither Robert's puppet nor his alter ego and was not acting as his agent with regard to the sale of the corporate assets and the liquidation of the corporation. The cases relied on by respondent -- Wrenn v. Commissioner, supra and Nye v. United States, supra -- are distinguishable, since these cases involved sales of property between spouses. There was no bona fide trust involved and no beneficiaries other than the wife. The courts considered it proper to determine whether the spouses were truly independent economic entities in deciding whether the selling spouse should be allowed to claim the benefits of section 453. Here, we have two separate economic entities, Robert and the Trust.[13]

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[13] We are satisfied that the Trust is not a sham created only for tax purposes, and must be respected.

Respondent argues, further, that the power, granted to Robert by the trust agreement, to appoint a co-trustee (including a "subservient co-trustee") authorized to make distributions of income and principal, constituted indirect control by him of the liquidation proceeds. Respondent argues, alternatively, that Robert could have directed this "subservient co-trustee" to distribute or withhold the distributions of income or principal, thereby forcing Ann Marie to administer the Trust in accordance with his wishes.

The trust agreement empowered Robert to designate any individual (other than himself) or a banking institution to serve as co-trustee, and to remove such trustee. Although Robert executed a waiver on June 7, 1980, he had the aforesaid rights during the years in issue. The record contains evidence that the aforesaid provisions were incorporated by Lipkind, Robert and Ann Marie's attorney, in order to avoid the inclusion of the Trust's corpus in Ann Marie's estate upon her death on the basis that she had a general power of appointment. See section 2041. Even assuming, arguendo, that the retention of these rights by Robert was done with the intention, and had the effect, of retaining indirect control over the liquidation proceeds, Herbert Zarrow was not appointed co-trustee by Robert until January 23, 1981, 2-1/2 years after the sale of the assets of Aero Gear to Lohmann and almost 2 years after Aero Gear was formally liquidated.

While actions of the parties subsequent to the transaction herein at issue may be considered to the extent that those actions cast light on their intentions, respondent's argument is not based on what really happened, but on what could have happened. A co-trustee was in fact appointed by Robert, and respondent does not contend that Zarrow was subservient to Robert's wishes. We therefore reject the arguments advanced by respondent.

The second prong of the test enunciated in Rushing v. Commissioner, 441 F.2d at 598, requires us to determine whether Robert possessed the economic benefit from the liquidation proceeds.

Respondent argues that the liquidation proceeds, held in trust for the benefit of Ann Marie and her issue, were to remain within the family group, and were to benefit the family group. A benefit to Ann Marie and her two children (who were also Robert's children), the argument follows, is also a benefit to Robert.

In response to respondent's argument, suffice it to say that Rushing v. Commissioner, supra, involved trusts created for the benefit of taxpayers' children. In applying the "economic benefit" prong of the test therein articulated, the Fifth Circuit did not attribute any importance to this fact. We do not think that this was due to oversight. Robert received only what section 453(b) entitled him to, a tax benefit. At no point could Robert have obtained possession of the liquidation proceeds in dispute. If we were to follow respondent's reasoning, Rushing v. Commissioner, supra; Weaver v. Commissioner, supra; Pityo v. Commissioner, supra; Davidson v. Commissioner, T.C. Memo. 1981-467; and Wilson v. Commissioner, T.C. Memo. 1980-288, would be overruled since they involved taxpayer's sale of stock on an installment basis to an irrevocable trust established for his family's benefit. Indeed, respondent concedes that "[t]here is no way [that] Robert could have obtained the Trust principal or income for himself."

We are also satisfied that there was a purpose other than tax-avoidance for the transactions herein at issue. This purpose was to provide for Ann Marie and the children, and to shield the Aero Gear stock from the risks associated with Robert's business ventures.

Respondent further contends that the sale of the assets of Aero Gear and the liquidation of the corporation were necessary steps of a prearranged plan.[14/] The prearranged plan argument only makes sense when a straw man is used as a conduit between the seller and the purchaser. See Griffith v. Commissioner, supra. Respondent has made no contention that there was any plan between Ann Marie and Lohmann. We also note that it was after (1) the taxpayers agreed, as shareholders and directors, to liquidate the corporations pursuant to the provisions of 337 and (2) substantially all of their assets were sold, that the

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[14/] See Rev. Rul. 73-157, 1973-1 C.B. 213.

taxpayers sold their stock in the corporation to the trustee of the trusts in Rushing v. Commissioner, supra.[15] Within a day the trusts authorized the corporations to distribute their assets in liquidation.

In the instant case, nearly 3 months elapsed between the sale of the stock of Aero Gear to the Trust and the sale of the assets. The record contains evidence that the Board of Directors of Mannesmann was required to approve the transaction, and that the matter was not submitted to Mannesmann until June of 1978. Even if Robert expected Ann Marie, as trustee, to sell the assets of Aero Gear and to liquidate the corporation, the Trust was created and the stock sold to it free of any precommitment for resale of the stock or assets to any third party.

Respondent points to the fact that the Trust contained assets insufficient to meet the obligations under the installment sale as additional evidence of prearrangement. Again, in Rushing, the total value of the assets transferred to the six trusts was $46,784.08. As a result of the installment sale of the stock of the two corporations to the trusts, obligations in the total amount of $625,000 resulted. The cases cited by respondent are distinguishable. In Lustgarten v. Commissioner, supra, we relied on the fact that the proceeds of the sale were held in escrow in disallowing taxpayer's use of the installment method, not on the buyer's (taxpayer's son) inability to make the installment payments. *Vaughn v. Commissioner*, *supra*, similarly involved an escrow agreement.

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[15] A total of six trusts were created. See 52 T.C. at 892.

We also do not find fatal to petitioners that the Trust gave a mortgage in the amount of $50,000, providing for a 14 percent rate of interest to Robert and Spitz. The amount is minimal, as compared to the liquidation proceeds, and the installments were being paid.

Finally, petitioners requested in their petitions that we award them litigation costs pursuant to the provisions of section 7430. As the instant proceeding was commenced after February 28, 1983, we have the authority to award "reasonable litigation costs," if appropriate. Section 7430, enacted by section 292(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, 572.

Rule 34 provides, in pertinent part, that "[a] claim for reasonable litigation costs shall not be included in the petition in a deficiency or liability action." In general, the time for making such claims is after the substantive issues have been resolved. Should petitioners desire to pursue this matter, they must comply with Rules 230 and 231.

To reflect the foregoing, as well as concessions made by the parties in docket No. 29077-83,

Decision will be entered under Rule 155 in docket No. 29077-83.

Decision will be entered for the petitioner in docket No. 29078-83.

742-B Ju 11.7/2: 1986-40

COMPLETED
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T. C. Memo. 1986-40

UNITED STATES TAX COURT

TOMMY G. PARSONS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 25918-82. Filed January 29, 1986

Tommy G. Parsons, pro se.

Gerald W. Douglas, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, Judge: Respondent determined a deficiency in petitioner's 1979 Federal income tax in the amount of $4,021.03. After numerous concessions as set out in the parties' first stipulation of facts, the issues remaining for decision are:

(1) Whether petitioner is entitled to a dependency exemption for Connie Foosness under section 151(e)(1)(A);[1]

(2) Whether petitioner is entitled to a deduction in an amount in excess of that allowed by respondent for other expenses (business expenses) specifically listed on Schedule C as "sawes, axes, chains" and "gas and oil"; and

(3) Whether petitioner is entitled to a deduction in any amount for the cost of goods sold in computing his gross profit from his logging business.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits thereto are incorporated herein by this reference.

Petitioner Tommy G. Parsons resided in Astoria, Oregon, at the time the petition was filed in this case. Petitioner timely filed his individual 1979 Federal income tax return (Form 1040) with the Internal Revenue Service Center in Ogden, Utah.

During 1979, petitioner and Connie Foosness lived together for 11 months at Route 1, Box 237A, Angora, Minnesota. Petitioner was not related to Connie Foosness by blood or marriage. During this period, Connie Foosness was not employed. There is no evidence in the record as to the amount of any support petitioner furnished for Connie Foosness during 1979.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

Petitioner's father was a logging contractor, and petitioner worked with his father in the logging business until 1966. At that time, petitioner sought and obtained an electrician's apprenticeship from the International Brotherhood of Electrical Workers, Local 294, in Hibbing, Minnesota. Petitioner spent the next four years in trade school, and in 1970, petitioner became a journeyman electrician.

About the time petitioner's father retired from the logging business, petitioner was experiencing difficulties in finding steady employment as an electrician. The construction industry was slowing down, and petitioner found himself out of work for extended periods of time. In an effort to supplement his sporadic employment as an electrician, petitioner purchased his father's logging equipment. Petitioner operated a logging business in Minnesota during 1979 and for part of 1980. Shortly after terminating his logging business, petitioner moved to Oregon.

During the year 1979, petitioner operated a logging business and was also employed as an electrician. Petitioner submitted a bid on a timber sale that was offered by the United States Department of Agriculture--Forest Service. The quantity of timber involved was small enough that petitioner could perform the work himself on a part-time basis during the periods of his unemployment as an electrician. Petitioner considered his logging business a part-time venture and worked as an electrician whenever the opportunity arose.

Petitioner was awarded the timber sale contract on February 21, 1979, at a total cost of $4,704.60. In addition, pursuant to the terms of the contract, petitioner was required to post a performance bond in the minimum amount of $300 or 10 percent of the bid. Petitioner complied with this requirement and posted $500 in cash, in lieu of a bond, on February 26, 1979. The termination date of this contract, as set forth therein, was June 30, 1979, but the term of the contract could be extended pursuant to the Contract Term Extension provision contained therein. The record does not clearly establish whether petitioner requested, or the Department of Agriculture granted, such an extension.[2]

The timber sale contract required petitioner to cut and remove the timber designated in the contract on or before the termination date. The timber to be cut under the contract stood on four acres of land in the Superior National Forest located in the Ranger District of Virginia, Minnesota. The name of this timber sale, as designated in the contract, was Big Pit-Compartment 62. The Payment Unit Schedule of the contract contained the following table setting forth the seven different species of timber purchased, the volume of each species to be cut, and the bid rates corresponding to the quality and the value of the differing species of timber listed.[3]

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[2] Since the record establishes that petitioner carried on his logging business during part of the year 1980, we think it likely that the contract term was extended.

Species and Product	Volume	Bid Rate	Total
White spruce sawtimber	3 Ccf	$20.00/Ccf	$ 60.00
Mixed pine sawtimber	34 Ccf	25.88/Ccf	879.92
Red and white pine sawtimber	71 Ccf	48.93/Ccf	3,474.03
White spruce pulpwood	1 Ccf	10.56/Ccf	10.56
Mixed pine pulpwood	17 Ccf	13.83/Ccf	235.11
Paper birch pulpwood	11 Ccf	3.18/Ccf	34.98
Aspen pulpwood	4 Ccf	2.50/Ccf	10.00
	141 Ccf Total		$4,704.60

The abbreviation Ccf, which is used above to designate a certain volume amount, is a unit of measurement commonly used in the forestry trade and represents 100 cubic feet. Moreover, the forestry trade refers to 100 cubic feet (Ccf) as a cunit.[4]

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[3] Respondent did not have an opportunity to examine this timber sale contract either prior to or during the trial. Pursuant to an oral order from the Court at the close of the trial, the record in this case was held open for 30 days to permit the parties to file a supplemental stipulation or other documentation with respect to the cost of goods sold issue. Within this permissible time frame, petitioner submitted to respondent copies of numerous documents. These documents consisted of 9 pages and included the timber sale contract executed between petitioner and the United States Department of Agriculture--Forest Service. Also included were a "special provisions" section and a "payment unit release" section, both pertaining to specific terms of the contract, together with two documents labelled "bill for collection." Respondent forwarded these documents to the Court, and by order these documents were received into evidence.

The Court does not condone petitioner's failure to cooperate with respondent's agents during the audit or during the pre-trial preparations. Petitioner's tactic of showing respondent's counsel a document but not permitting him to copy it was wholly improper and to be condemned. Petitioner is admonished to desist from any such tactics in any future case in this Court. Nonetheless, the Court wished to decide this case on as complete a record as possible and thus kept the record open after the trial as noted above.

During the year 1979, petitioner was employed as an electrician at three different construction sites. He drove to and from these construction sites each day in his pickup truck and incurred various vehicle expenses. Petitioner did not retain receipts or records to compute these expenses but determined his local transportation expenses at the end of the year by referring to his paycheck stubs and his employee W-2 forms. Petitioner used his W-2 forms to establish the different locations at which he had worked during the year. Petitioner knew the distances between his house and the various construction sites. By referring to his paycheck stubs, petitioner determined how many 8-hour shifts that he had worked at each construction site. Petitioner counted each 8-hour shift as a trip to and from the jobsite. Petitioner determined how many trips that he had made during the year to these various temporary construction sites and consequently computed the total mileage that he had traveled.

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[4] The contract neither indicates that the abbreviation Ccf represents 100 cubic feet nor that 100 cubic feet is commonly referred to as a cunit. Petitioner testified that 100 cubic feet of timber is equivalent to 1 qunit [sic] and that he purchased 141 qunits [sic] under the contract. We find petitioner's testimony on this matter both credible and reliable. See Terms of the Trade, A Handbook for the Forest Products Industry, 21, 108 (W. Dean & D. Evans ed. 1978).

Petitioner also expended an undetermined amount of time in his logging business during 1979 and had gross receipts of $6,917 from that business. Petitioner used the same pickup truck in his logging business that he used to travel to and from the construction sites during the periods while he was employed as an electrician. However, petitioner did not maintain any records to establish when he used his truck in the logging business or when he drove it to the construction sites. Petitioner generally did not work in the logging business while he was working as an electrician. Petitioner contracted out the work that had to be done in the logging business during the periods that he was working as an electrician and could not perform the work himself.

Petitioner incurred various expenses in connection with his logging business in 1979 and calculated these expenses from some cancelled checks and various receipts he retained. However, petitioner did not maintain any log books, diaries, or other records of any kind relating to his logging business.[5]

On his 1979 Federal income tax return (Form 1040), petitioner claimed a dependency exemption for Connie Foosness. Petitioner also reported a business loss in the amount of $3,426 from his logging business. On Schedule C, petitioner reported gross receipts from his logging business in the amount of $6,917, cost of goods sold in the amount of $2,635, and resulting gross profit in the amount of $4,282. Petitioner claimed depreciation and various business expenses in connection with his logging business totalling $7,708, which resulted in the reported loss for the year 1979 in the amount of $3,426. In his statutory notice of deficiency dated August 3, 1982, respondent disallowed, among other things, the dependency exemption that petitioner claimed for Connie Foosness, the cost of goods sold item, and the depreciation and business expense items for the logging business.[6] The depreciation and most of the business expense items were ultimately disposed of prior to trial.[7]

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[5] We find this rather peculiar since petitioner testified that he had been audited by the Internal Revenue Service every other year since 1966, and consequently, knew which expenses had to be substantiated with receipts. Petitioner stated that he retained only those receipts that pertained to expenses incurred in the logging business, because those were the only receipts that he would need to produce in the event of any audit. Had petitioner maintained proper records and produced them during the audit, we think it unlikely that this litigation, involving as it does primarily substantiation issues, would have been necessary.

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[6] Petitioner had also claimed a Federal tax credit for special fuels and oils in connection with his logging business. We note a mathematical error on petitioner's Form 4136 in the computation of his Federal gasoline tax credit. Petitioner reported 600 gallons of fuel for nonhighway use and claimed a credit in the amount of $72. However, the applicable credit rate for the year in issue, as provided on Form 4136, for computing petitioner's Federal gasoline tax credit was $.02 per gallon. Accordingly, petitioner was only entitled to claim a Federal gasoline tax credit for the year in issue in the amount of $12 (600 x $.02) at most. The record does not indicate that respondent corrected this mathematical error. Moreover, the statutory notice of deficiency does not reflect that respondent disallowed any portion of petitioner's Federal gasoline tax credit for the year in issue.

[7] Respondent made numerous concessions once petitioner produced whatever documentation he had, but such production was accomplished only after respondent was forced to file formal discovery motions which the Court granted. Petitioner did not comply with the Court's order and finally produced his documents the day before the trial and only after the Court threatened to

(footnote continued)

OPINION

Except perhaps for the dependency exemption issue, the issues remaining for determination are purely factual and essentially matters of substantiation. Deductions are a matter of legislative grace, and petitioner has the burden of establishing that he is entitled to the deductions he claimed. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Dependency Exemption

Petitioner claimed a dependency exemption for Connie Foosness for 1979. He and Connie Foosness lived together for 11 months of that year. They were not related by blood or marriage during the time they lived together. Connie Foosness was not employed during this period, and petitioner contends that he was her sole means of support.

Section 151(e)(1)(A) allows "[a]n exemption * * * for each dependent (as defined in section 152) whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $1000." Section 152(a)(9) defines "dependent" to include (1) an individual "over half of whose support, for the calendar year in which the taxable year of the taxpayer begins,

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(footnote continued from previous page)
impose sanctions. In view of the numerous concessions made by respondent after reviewing petitioner's documentation, we think the result the Court has reached after careful study of the documents is close to what might have been achieved during the audit had petitioner cooperated to substantiate the items he claimed and had he eschewed frivolous constitutional arguments and improper delaying tactics. See nn. 3, 5, supra.

was received from the taxpayer," and (2) such "individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 143, of the taxpayer) who, for the taxable year of the taxpayer, has as [her] principal place of abode the home of the taxpayer and is a member of the taxpayer's household."[8]

It is not necessary under section 152(a)(9) that an individual be related to the taxpayer to qualify as his dependent. However, in order for an unrelated individual to qualify as a dependent under section 152(a)(9), such individual must live with the taxpayer and be a member of the taxpayer's household throughout the *entire* taxable year of the taxpayer. Sec. 1.152-1(b), Income Tax Regs.; *Trowbridge v. Commissioner*, 268 F.2d 208 (9th Cir. 1959), affg. per curiam 30 T.C. 879 (1958); *McMillan v. Commissioner*, 31 T.C. 1143, 1145-1146

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[8] SEC. 152. DEPENDENT DEFINED.

(a) General Definition.--For purposes of this subtitle, the term "dependent" means any of the following individuals over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer (or is treated under subsection (c) or (e) as received from the taxpayer):

* * *

(9) An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 143, of the taxpayer) who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household.

(1959).[9] Therefore, since Connie Foosness was not a member of the petitioner's household for the entire taxable year in issue, she does not qualify as a dependent under section 152(a)(9), and petitioner is not entitled to claim a dependency exemption for her. In any event, petitioner failed to substantiate the amount of any support he furnished for her, and thus failed to prove that he furnished over half of her support as required by section 152(a).

Logging Business

The remaining issues are simply matters of substantiation. As noted above, petitioner has the burden of proving that he is entitled to the deductions he claimed, which includes establishing that he in fact incurred the expense or other item deducted. In regard to petitioner's logging business, respondent in effect accepted the gross receipts figure and disallowed all deductions relating thereto, including cost of goods sold.

Cost of Goods Sold

On Schedule C attached to his 1979 Form 1040, petitioner reported gross receipts from his logging business in the amount of $6,917 and deducted from this amount the cost of goods sold in the amount of $2,635 to arrive at a gross profit figure in the amount of $4,282.[10] Respondent disallowed the cost of goods sold deduction in its entirety and contends that petitioner completely failed to produce adequate documentation to prove or substantiate any amount. In addition, respondent argues that approximating the amount of the cost of goods sold is inappropriate under the rule established in Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), because there exists no reasonable basis for its applicability. Respondent simply disregards the fact that petitioner spent at least $4,704.60 for timber in 1979.

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[9] See also Rodenbaugh v. Commissioner, T.C. Memo. 1981-593.

[10] Gross income derived from business means "the total sales, less the cost of goods sold, plus any income from investments and (footnote continued)

The cost of goods sold equals opening inventory at the beginning of the taxable year, plus the cost of inventory acquired during such year, minus the closing inventory at the end of the taxable year. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 530 n. 9 (1979). Normally, the opening inventory at the beginning of a taxable year is the ending inventory carried forward from the close of the previous taxable year. However, petitioner began his logging business in 1979 and therefore had no ending inventory from 1978 to carry forward to 1979 as opening inventory. Consequently, petitioner's total inventory of his logging business for the year 1979 derived solely from purchases that he made during such year. The record indicates that petitioner made only one such purchase during 1979, the $4,704.60

(footnote continued from previous page)
from incidental or outside operations or sources." Section 1.61-3(a), Income Tax Regs.

timber sales contract with the Department of Agriculture--Forest Service. Accordingly, petitioner's total inventory of his logging business for the taxable year 1979 was $4,704.60.

Petitioner could have calculated his cost of goods sold in one of two ways. First, he could have inventoried the timber that remained unsold at the close of the 1979 taxable year and subtracted this figure from the total inventory for such year. Second, petitioner could have calculated the cost of the timber that he actually sold during the 1979 taxable year. Respondent argues that the evidence presented neither provides an ascertainable standard to measure the quantity of timber that petitioner allegedly sold during 1979 nor verifies the accuracy of the ending inventory figure in the amount of $2,070 as indicated on his return. While the evidence is sparse, we do not think it warrants complete denial of any cost of goods sold.

Petitioner says that his total inventory for 1979 consisted of 141 cunits of various species of timber at an average cost of $33.37 per cunit (total cost of $4,704.60 ÷ 141 cunits). We think this average cost figure is meaningless in view of the different species of timber, different types (sawtimber vs. pulpwood), and great variations in petitioner's own bid prices per cunit (Ccf) of different types of timber. Petitioner testified that he sold 78.98 cunits of timber during 1979 which, according to his calculations, is equivalent to the cost of goods sold deduction that he claimed for the year in issue in the amount of $2,635 (78.98 x $33.37 per cunit). This testimony was based on what someone had allegedly told him over the telephone the morning of the trial, and we disregard such hearsay.[11] There is no probative evidence in the record as to the number of cunits (Ccf) of timber petitioner sold in 1979. Petitioner further testified that he carried forward to 1980 as opening inventory the 62.02 cunits of timber that remained unsold at the close of the taxable year in issue, which he says is equivalent to $2,070 (141 cunits minus 78.98 x $33.37). Again, there is no probative evidence to establish the cunits of timber that remained unsold at the end of 1979. Also, the contract with the Forest Service was a contract to cut and remove the timber designated in the contract, and there is no evidence that petitioner ever cut and removed all the timber he was permitted to cut.

Petitioner did not keep business records regarding the activities in his logging business. The only documents that petitioner ever presented to respondent or this Court in regard to the amount of timber were three receipts representing petitioner's gross timber sales in 1979.

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[11] The Court is inclined to think petitioner simply backed into this figure by taking the cost of goods claimed on his return ($2,635) and dividing it by his purported average cost per cunit ($33.37).

The sum of these receipts total $6,917, which corresponds with the amount petitioner reported as gross receipts on Schedule C. However, there is no method, reasonable or otherwise, for translating the quantity of timber represented on the face of these receipts into 78.98 cunits or any other number of cunits.[12] Standing alone, these three receipts are not adequate to support petitioner's cost of goods sold deduction. Respondent argues that petitioner failed to establish that he actually sold any timber in 1979 and therefore is not entitled to any cost of goods sold deduction. Respondent complains, with considerable justification, that petitioner did not allow respondent the opportunity to make copies of these receipts prior to trial to conduct an independent verification of their validity.

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[12] The first receipt, dated June 12, 1979, indicates that petitioner sold a total of 122 Norway pine poles of various lengths for a total price of $4,937.50. However, the receipt indicates that the sales price was calculated by the lineal foot (lf) rather than by the cubic foot. The second receipt, dated July 25, 1979, indicates that petitioner sold two loads of Pine Bolts for a total purchase price of $1,467.40. The last receipt consists of a photocopy of two check stubs from Potlatch Corporation, Northwest Paper Division. One of the check stubs indicates that check #016739 was purportedly issued in the amount of $386.95. The other check stub indicates that check #016885 was purportedly issued in the amount of $125.35. There is no description of the type or amount of timber involved. We have accepted petitioner's testimony that these receipts represent his sales of timber from the Forest Service contract, but that fact is not evident on the receipts themselves. It is unfortunate that petitioner would not permit respondent to copy these receipts before the trial and investigate as to exactly what the receipts covered.

Consequently, respondent argues that all three receipts are totally lacking in credibility and should be given no force and effect.

While the receipts are not on their face sufficient to support petitioner's claimed cost of goods sold deduction in the amount of $2,635, and while petitioner's evidence leaves much to be desired, we think petitioner is nonetheless entitled to some amount as cost of goods sold. Petitioner paid the Department of Agriculture--Forest Service an amount of $4,704.60 for timber in 1979. While we do not know how much timber or what types that petitioner cut and removed under that Forest Service contract, petitioner had gross receipts from his logging business in 1979 in the amount of $6,917. We think it necessarily follows that petitioner is entitled to deduct some amount in computing his gross profit from his logging business that represents the cost he incurred in purchasing this timber.

When a taxpayer proves that some part of an expenditure was made for deductible purposes and when the record contains sufficient evidence for us to make some reasonable approximation, we will do so. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Although the evidence is less than satisfactory for this purpose, we will do our best with the materials at hand, "bearing heavily * * * upon the taxpayer whose inexactitude is of his own making * * *." 39 F.2d at 543-544.

Petitioner was in the logging business for 1979 and part of 1980. The record indicates that petitioner had no opening inventory at the beginning of 1979 and that petitioner's total inventory of timber in 1979 derived solely from the one purchase in the amount of $4,704.60. Accordingly, based on all the facts and circumstances, but bearing heavily against petitioner for the inexactitude of his evidence, we conclude that petitioner is entitled to a cost of goods sold deduction in 1979 in the amount of $1,500.

Business Expenses

Gas and Oil Expense

On his Schedule C, petitioner claimed a deduction for gas and oil expenditures in the amount of $980, purportedly incurred in his logging business. Most of the receipts in support of this item do not bear petitioner's name, none of the receipts contain any license number or vehicle number to connect these receipts with petitioner's logging business, and several of the receipts are not even dated. Petitioner refused to allow respondent to make copies of these receipts until the day before trial, and consequently, respondent had no opportunity to verify the authenticity of these receipts. Except for his testimony, purporting to identify these receipts, petitioner presented no additional evidence to document that these gas and oil receipts represented expenses paid and incurred in his logging business. As noted earlier, petitioner did not maintain any log books, diaries or other records of any kind relating to his logging business. Respondent complains that determining whether these gas and oil receipts represent valid business expenses paid and incurred in petitioner's logging business or whether the receipts represent nondeductible personal expenditures or expenses incurred while petitioner worked as an electrician requires pure speculation. While we are most sympathetic to respondent's complaints, we will not wholly disallow the item.

Petitioner was engaged in the logging business during the taxable year 1979. Petitioner had gross receipts from the sale of timber during such year in the amount of $6,917. On Schedule C, petitioner claimed, and respondent has now allowed, a depreciation deduction totalling $1,900 on four pieces of equipment that he used in his logging business. In addition, petitioner claimed, and respondent has now allowed, various other deductions relating to petitioner's logging business, including expenses for contract labor, truck rental, and sawmill rental. It would indeed be anomalous to find that petitioner operated a logging business during 1979 without incurring any expense for "gas and oil." We think the very nature of petitioner's business mandates a finding to the contrary.

The record thus establishes that petitioner incurred gas and oil expenses in his logging business during 1979, and we will determine the amount petitioner is entitled to deduct. While petitioner claimed gas and oil expenses on Schedule C in the amount of $980, the gas and oil receipts that petitioner presented at trial to substantiate these expenses totalled

$1,039.86. After examining these receipts, we found several of them to be totally lacking any probative value. Two of the receipts, each in the amount of $21.50, dated September 25, 1979, were duplicates. Moreover, we found that four of the receipts totalling $55.89 were not dated. After discarding one of the duplicate receipts in the amount of $21.50 and the four undated receipts totalling $55.89, we considered the remaining receipts totalling $962.47. The real problem is that petitioner used his pickup in both his logging business and in his travel to the construction sites where he worked as an electrician. Although the evidence is far from clear, we conclude that several of these receipts totalling $235.45 provide a sufficient nexus to petitioner's logging business and adequately represent gas and oil expenses incurred therein during the year in issue.[13]

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[13] Of these receipts totalling $235.45, an amount of $207.45 represents the purchase of gasoline in cans or barrels. While these receipts do not bear any vehicle number or license number or indicate any specific use, and while most of these receipts are made out to cash and do not bear petitioner's name, we think that it is reasonable to conclude that operating a logging business requires quantities of gasoline to be located on the jobsite for use in the various pieces of equipment utilized in such an operation. Accordingly, we think that the receipts indicating the purchase of gasoline in cans and barrels are reasonably attributable to expenses incurred in petitioner's logging business. The remaining portion of the $235.45 consists of two receipts indicating the purchase of Penta concentrate (Pentachlorophenol - A chemical used in wood preserving; it is usually applied under pressure so that it will penetrate the wood. Terms of the Trade, A Handbook for the Forest Products Industry, 66 (W. Dean & D. Evans ed. 1978)). Both receipts are in the amount of $14 and are dated June 9 and 18, 1979, respectively. Prior to trial, respondent allowed a business expense deduction in the amount of $20.77 (sawes, axes, chains) for a yard and garden sprayer. The receipt indicates that the
(footnote continued)

The remaining gas and oil receipts that we examined cannot be specifically identified with petitioner's logging business. These receipts indicate expenditures for items that are germane to but not sufficiently peculiar to petitioner's logging business for us to find the necessary nexus. However, when a taxpayer proves that some part of an expenditure was made for deductible purposes and when the record contains sufficient evidence for us to make a reasonable allocation, we will do so. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). However, the record in this case provides no reasonable basis for making such an allocation.[14] This is particularly true since petitioner also

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(footnote continued from previous page)
sprayer was purchased to apply Penta concentrate to poles. We think that the two receipts totalling $28 for the purchase of the Penta concentrate are also reasonably attributable to expenses incurred in petitioner's logging business.

[14] Petitioner testified that just prior to trial, he examined and totalled his gas and oil receipts and arrived at a figure a little in excess of the amount of $980 claimed on his return. Moreover, he stated that $728 of the total claimed represented expenses for gasoline, and the remaining portion represented expenditures for hydraulic oil, as shown on the receipts. Petitioner also testified that the amount of $728 represented approximately 970 gallons of fuel at an average cost of 75 cents per gallon. Petitioner claimed that this fuel was used in connection with the timber contract with the Forestry Service. While this quantity of fuel and hydraulic oil might indeed represent a reasonable consumption if all of that timber was in fact cut and removed, the record does not support such an allocation. Petitioner kept no contemporaneous business records of the daily activities in his logging business. Except for petitioner's self-serving and wholly uncorroborated testimony, the record is devoid of any evidence that even remotely correlates this quantity of fuel and hydraulic oil with the cutting and the removal of 141 cunits of timber. We note that petitioner reported 600 gallons of fuel for nonhighway use and claimed a Federal tax credit for such usage on Form 4136.

(footnote continued)

used his pickup in his work an an electrician, and these receipts may well be related, at least in part, to that local transportation for which respondent has already allowed a deduction. Under such circumstances, a deduction based on the Cohan rule in excess of the $235.45 would be "unguided largesse." Williams v. United States, 245 F.2d 559 (5th Cir. 1957).

"Sawes, Axes, Chains"

On his Schedule C, petitioner claimed a business deduction in the amount of $409 for "sawes, axes, chains" in connection with his logging business. Just before trial and based upon receipts petitioner finally submitted for respondent's inspection, respondent conceded expenses for "sawes, axes, chains" in the amount of $131.91. Petitioner presented these same receipts to the Court at the trial and testified generally that they are what they purport to be.

The record establishes that petitioner incurred some expenses for "sawes, axes, chains" in his logging business during 1979, and we must determine if the amount exceeded the $131.91 conceded by respondent. After examining petitioner's receipts, we found the year of purchase missing on two of the receipts totalling $23.45 and disregarded them. Of the remaining

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(footnote continued from previous page)
Respondent disallowed petitioner's gas and oil expenses in their entirety, but failed to make an adjustment with respect to the gasoline allegedly qualifying for the Federal fuel tax credit when determining petitioner's deficiency for the year in issue. We consider this omission a mere oversight by respondent, which does not indicate that petitioner actually used 600 gallons of gasoline for nonhighway use in his logging business.

receipts, we found five totalling $124.07 that are reasonably attributable to petitioner's logging business.[15]

Of the remaining receipts that we examined, petitioner has failed to connect these receipts with his logging business. Moreover, the record in this case provides absolutely no reasonable basis for making an allocation based on the *Cohan* rule. *Cohan v. Commissioner*, *supra*. Under such circumstances, any further deduction based on the *Cohan* rule would be "unguided largesse". *Williams v. United States*, *supra*. Accordingly, petitioner is entitled to an additional deduction for "sawes, axes, chains" expenses in the amount of $124.07.

In summary, petitioner is not entitled to claim a dependency exemption for Connie Foosness; petitioner is entitled to a cost of goods sold deduction in the amount of $1,500, a deduction in

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[15] The following is a list of the receipts that represent the additional expenses allowed in the amount of $124.07:

Seller	Date	Item(s)	Total Amount
1. Jonsereds Chain Saw	March 9, 1979	Chain Bar	$45.76
2, L & M Supply	April 28, 1979	Tractor Battery	32.11
3. Ace Hardware	June 13, 1979	Sharpening Stones	9.84
4. L & M Supply	June 13, 1979	Ax File	15.98
5. F & S Radiator Service	December 13, 1979	Clean and Repair John Deere Radiator	20.38

Although most of these receipts do not bear petitioner's name, we think the items or services purchased, as reflected on these receipts, are sufficiently associated with petitioner's logging business to allow a deduction.

the amount of $235.45 for gas and oil expenses, and a deduction in the amount of $124.07 for "sawes, axes, chains" expenses in addition to the $131.91 previously allowed by respondent.[16]

To reflect the foregoing,

Decision will be entered
under Rule 155.

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[16] A corresponding adjustment to petitioner's self-employment tax will be necessary to reflect these changes on petitioner's Schedule C.

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UNITED STATES TAX COURT

GEORGE J. KITCHER AND BARBARA E. KITCHER, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24321-82. Filed January 29, 1986

Thomas P. Cullen, Jr., for the petitioners.

William S. Garofalo and Richard J. Sapinski, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, Judge: Respondent determined deficiencies in petitioners' 1980 Federal income taxes and section 6653(a)[1] additions to tax as follows:

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

ORIGINAL

Petitioner	Deficiency	Sec. 6653(a) Addition to Tax
George J. Kitcher	$9,329.24	$466.46
Barbara E. Kitcher	5,517.03	275.85

After concessions,[2] the issues for decision are (1) whether petitioners are precluded from claiming joint filing status for the taxable year in issue, and (2) whether the payment in the amount of $5,100 that petitioners made to become ministers in the Freedom Church of Revelation was expended for tax advice or for legal representation and deductible under section 212(3).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

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[2] On the Schedule A attached to each petitioner's 1980 Federal income tax return, the only item claimed as an itemized deduction on either return was charitable contributions. Petitioners have now conceded that respondent properly disallowed the amounts claimed as charitable contributions on their 1980 tax returns, and both have conceded that the negligence addition under section 6653(a) is applicable to any deficiency. The parties also have now stipulated that:

1. Petitioner George Kitcher is entitled to deductions of $3,433 for taxable year 1980.

2. Petitioner Barbara Kitcher is entitled to deductions of $2,799 for taxable year 1980.

3. The deductions are itemized deductions and will only reduce taxable income to the extent they exceed the zero bracket amount, pursuant to section 63(d).

Petitioners, George J. Kitcher (Mr. Kitcher) and Barbara E. Kitcher (Mrs. Kitcher), husband and wife, resided in Flushing, New York, at the time their petition was filed in this case. Each petitioner timely filed an individual 1980 Federal income tax return (Form 1040) with the Internal Revenue Service Center in Holtsville, New York. Petitioners were husband and wife at the close of the 1980 taxable year and could have filed a joint return for such year, but instead they filed separate returns with each claiming the filing status of "married filing separately." Petitioners did not file any amended return claiming joint filing status for 1980 at any time before the filing of the petition in this case.

Mr. Kitcher is employed with the New York Telephone Company as a telephone technician, having been employed with this company for some 19-1/2 years. His annual salary was approximately $30,000. Mr. Kitcher neither presently owns nor has ever owned his own home. Mr. Kitcher is presently married to Barbara E. Kitcher, the co-petitioner in this case. During the year involved in this case, he had one child from a previous marriage.

At all times relevant to this case, Mrs. Kitcher was employed with the New York Telephone Company as a customer service representative, having been employed with the company for about 15 years. Her annual salary at the time she left that employment was approximately $20,000.

Petitioners George and Barbara Kitcher were married on July 26, 1980. At some point during 1980, petitioners obtained credentials as ministers in the Freedom Church of Revelation (hereinafter FCR).

When Mr. Kitcher was first introduced to the FCR, he was experiencing financial problems. He was then recently divorced, paying alimony to his former wife, and searching for a means to save money and to get ahead. During this period, Mr. Kitcher met a minister from the FCR who invited him to attend an FCR seminar. Such recruiters were paid commissions by the FCR for each new member. In the course of his recruitment, Mr. Kitcher was shown copies of tax returns that other ministers in the FCR had filed in previous years, together with copies of refund checks that had been issued by the Internal Revenue Service in connection with those returns.

Petitioners attended an FCR meeting that was held at a hotel at LaGuardia Airport. They were told at this meeting that becoming a minister in the FCR was a legal way to avoid Federal and state taxes. Petitioners' purpose in becoming ministers in the FCR was to become legally tax exempt. The record does not indicate that any professional person, knowledgeable in the tax law and competent and qualified to render tax opinions, was present at petitioners' initial meeting or at any subsequent meetings or that such a qualified professional person ever represented to petitioners that these purported tax benefits were valid. Any representations to petitioners were made by other

FCR ministers. Prior to joining the FCR, petitioners did not seek the legal advice or opinion of any outside accountant or attorney concerning the correctness of the FCR's representations that becoming a minister in the FCR was a legal means to avoid taxes.

The FCR membership procedures required prospective members to make an initial "donation" or payment to the FCR to become a minister. The initial cost to petitioners to become ministers in the FCR and to acquire this purported tax-exempt status was $5,100. Petitioners considered the $5,100 to be a good investment and a good bargain if they never had to pay any more taxes. Petitioners made their "donation" to the FCR by a check dated June 20, 1980, in the amount of $5,100. The stated purpose of this $5,100 payment is indicated by a handwritten notation on the bottom right-hand corner of the check that reads: "Donation-Educational." Petitioners do not know and the record does not show how the FCR used the $5,100 payment made by petitioners. However, Mr. Kitcher was told that a portion of the $5,100 membership fee would be used to build a holistic health center, a portion to fund the FCR's legal department, and the remaining portion would be used to acquire various publications and to recruit new members. Some part of petitioners' payment was probably paid as a commission to the FCR minister who recruited them.

In return for the payment of $5,100, petitioners received their FCR minister credentials and their certificates of sacramental authority from the FCR that purportedly would enable them to perform marriages, baptisms, and other sacraments.[3] Petitioners also received an FCR charter designating them as a chapter or local church of the FCR. Petitioners used their ministerial credentials to receive fringe benefits such as discounts in furniture and clothing stores and exemption from local sales taxes. In addition, as ministers in the FCR, petitioners were entitled to and did receive a commission for bringing a new member into the FCR. Petitioners received this commission in a year subsequent to that before the Court.

Petitioners also received various government publications as a part of the package they were given upon becoming ministers in the FCR. Petitioners received Publication 517, relating to social security for clergy members, and were told that this publication would allow them as FCR ministers to withdraw from social security. Petitioners received Publication 526 relating to charitable contributions and were told that any charitable contributions they made to the FCR would qualify as a charitable deduction pursuant to this publication.[4] Petitioners also received a copy of the determination letter dated June 8, 1979, issued by the Internal Revenue Service, that stated that the FCR of Hohokus, New Jersey was exempt from Federal income tax under section 501(c)(3).[5]

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[3] Mr. Kitcher was told that New York required a registration procedure before ministers could perform marriages and baptisms. Mr. Kitcher never bothered to register. The record does not indicate whether Mrs. Kitcher ever registered or ever purported to perform any marriages. The Court makes no finding as to whether or not any FCR minister is legally authorized to perform a valid marriage in New York or elsewhere. Petitioners argue on brief that such marriages, including their own which they say was performed by an FCR minister on a sailboat in New York bay, are valid. There is no probative evidence in the record as to the facts of petitioners' marriage. Respondent, relying upon the rates for married persons filing separately, has raised no issue as to petitioners' marital status. The Court will assume for purposes of this case that petitioners' marriage is valid.

Petitioners also received a photocopy of a 1979 tax return that was filed by Rev. Leonard Scarnato, Jr., a minister in the FCR. On the back of this return was photocopied a United States Treasury check dated May 30, 1980, made payable to "LEONARD JR SCARNATO" in the amount of $6,990.12, which was the exact amount claimed on the return as a refund. The amount claimed as a refund consisted of Federal income tax withheld in the amount of $5,638.40 and excess FICA and RRTA tax withheld in the amount of $1,351.72. Mr. Scarnato filed this return purportedly as an agent and minister of the FCR, claiming he was under a vow of poverty and therefore was exempt from taxation pursuant to section 3401(a)(9). The return showed adjusted gross income in the amount of $23,191.20, taxable income for the same amount, and $0 tax due. Petitioners were instructed by the FCR to use this tax return as a model and to file their tax returns in exactly the same manner.[6]

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[4] Petitioners also received Publication 525 (relating to taxable and nontaxable income); Circular E and Supplement Reprint (Employer's Tax Guide); an application for Exemption from Self-Employment Tax (Form 4361); and a copy of a page from the Supplement to Publication 78 that listed the FCR of Hohokus, New Jersey, as qualified to receive charitable contributions. We note that these various government publications are furnished by the Internal Revenue Service free of charge.

[5] The tax-exempt status of the parent FCR was retroactively revoked effective for all tax years beginning with the year ended December 31, 1978, by a letter dated September 30, 1982, from the Acting Associate Chief of the Internal Revenue Appeals office, Mid-Atlantic Region. The parent FCR challenged this revocation in the District Court of the District of Columbia pursuant to section 7428(c). The District Court sustained the Commissioner's retroactive revocation. Freedom Church of Revelation v. United States, 588 F. Supp. 693 (D.D.C. 1984).

The FCR held numerous meetings from time to time and required the ministers to attend at least three meetings each year. Generally, these meetings were held in conference rooms at various hotels. Each meeting usually began with a prayer and the Pledge of Allegiance. Occasionally, someone would read some articles or briefly list donations that the FCR had made to various charities. The stated purpose of these meetings was to further the ministers' education and philosophy in the FCR together with the tenets of their religion. Petitioners attended several of these meetings. Only 10 percent of each meeting was devoted to what could be called religious instruction. The main purpose of these meetings was to review the latest information and documents relating to the operation of each minister's church, including the proper procedure to maintain their tax-exempt status. The meetings included instruction on the preparation of income tax forms, instruction on how to file for exemption from social security and from the employer's withholding provisions, and also the proper procedure in filing state sales tax exemption forms. These meetings generally included lectures from Joseph Coniglione, the bishop in the FCR, and were usually concluded with a question and answer period. The lectures included nutrition, diet, and holistic health matters. Occasionally, questions were directed to William DeMarco, who was legal counsel for the FCR, questions involving the authority of the state to incarcerate members for failing to produce documents or membership lists. The record, however, indicates that Mr. DeMarco was not legal counsel for the FCR at the time petitioners initially became members.

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[6] Petitioners also received a photocopy of the back of a tax return that was purportedly filed by another minister in the FCR. On this return was photocopied a United States Treasury check dated May 16, 1980 made payable to George L. The last name on the check and the last name on the signature line on the return were whited out. The return indicates that George L. filed this return purportedly as an agent of the church and claimed exempt status pursuant to section 3401(a)(9).

William DeMarco is a practicing attorney, licensed in the State of New Jersey. He has a general practice and handles both criminal and civil matters. About 60 percent of his practice consists of criminal defense work, and the remainder consists of general litigation that includes matrimonial matters.
Mr. DeMarco does not have any post-graduate education in the area of taxation. He has never written any articles in the tax field, and he does not hold himself out to the public as a tax expert.

Mr. DeMarco first became involved with the FCR and Joseph Coniglione about the middle or the latter part of 1980. At that time, a board member of the FCR was in jail on contempt charges stemming from state grand jury proceedings. Mr. DeMarco was retained by the FCR to effect the release of the incarcerated board member. Thereafter, Mr. DeMarco began representing Joseph Coniglione and the FCR on an irregular basis in various matters, but eventually Mr. DeMarco became involved on a more regular basis.

About the middle of 1981, Mr. DeMarco became involved with the FCR on a regular basis. Mr. DeMarco handled various non-tax legal matters for Mr. Coniglione and the FCR. Mr. Coniglione was under a criminal investigation by the State of New Jersey. There were First Amendment problems concerning the literature published by the FCR, particularly in regard to holistic healing. There were problems concerning the general treatment that the FCR received from various government agencies, again related to holistic healing. At this time, Mr. DeMarco was retained as general counsel by the FCR to handle these various matters and to defend the deductibility of donations to the FCR. However, Mr. DeMarco did not personally handle these tax matters for the FCR. At first he hired Harvey Zeller to handle the FCR's tax work on a per diem basis and later hired Steve Gelb to handle its tax work on a regular basis.[7] During the period of his involvement, Mr. DeMarco occasionally attended the meetings held by the FCR. At first he was introduced at these meetings as the attorney for Jerry Heineman, the board member who had been incarcerated. Later, he was introduced as general counsel of the FCR. Harvey Zeller and Steve Gelb were also mentioned occasionally at the FCR meetings as lawyers representing the church. At these meetings, Mr. DeMarco was available to answer questions from the ministers. These questions included issues concerning the First Amendment, questions concerning the incarceration of their fellow church member, Jerry Heineman, and practical procedural questions from ministers who were currently going through an audit with the Internal Revenue Service. However, Mr. DeMarco always referred the ministers with tax questions to Steve Gelb. The record does not indicate that Mr. DeMarco answered specific questions from petitioners at these meetings or that he ever personally referred petitioners to Steve Gelb. Petitioners never heard Mr. DeMarco speak at any of the meetings that they attended.

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[7] Taxation was Steve Gelb's area of expertise. Any communication that petitioners had with Mr. DeMarco's office was usually through Steve Gelb. Petitioners never spoke with Mr. DeMarco. Mr. Gelb, however, was not present at trial, and the record does not indicate the degree of his actual involvement with petitioners, except for filing their petition in this case.

Mr. DeMarco's firm became involved with the individual FCR ministers' tax problems only after the tax returns were filed and audited by the Internal Revenue Service. Generally, the ministers were instructed to contact Mr. DeMarco's office regarding any problems they encountered with the Internal Revenue Service that related to the deductibility of donations made to the FCR. In the normal case, the ministers would forward to Mr. DeMarco's office the notice of deficiency that they received from the Internal Revenue Service, and Mr. DeMarco's office would file a petition with the Tax Court contesting the deficiency. Mr. DeMarco did not bill the ministers individually for this service but received an overall retainer each month from the FCR for all the work he and his firm had done, including non-tax matters. As general counsel, Mr. DeMarco received approximately $4,000 to $5,000 each month in legal fees from the FCR. He computed these amounts on an hourly rate based on the time that he personally expended and the cost of having an associate devoting most of his time to the FCR, including any expenses that were incurred.

As general counsel for the FCR, Mr. DeMarco neither rendered opinions to church members regarding the deductibility of the amounts paid to the FCR nor advised church members regarding the preparation of their income tax returns. Moreover, he did not give instructions on the preparation of tax returns during any of the meetings that he attended. Mr. DeMarco's firm reviewed tax returns for the ministers only in the event of an audit.

In addition, he never rendered opinions to prospective church members regarding the alleged tax benefits of becoming a minister in the FCR. Mr. DeMarco never met or spoke with petitioners. Moreover, Mr. DeMarco never reviewed any documents relating to the FCR for Mr. Coniglione regarding their legality. The FCR had been in operation for some time before Mr. DeMarco ever became associated with it in any capacity.

Occasionally, ministers under audit would come to Mr. DeMarco's office and, in the course of conversation, espouse clear misstatements of the law that some other minister in the FCR had told them. Steve Gelb would then send a memo to the minister(s) responsible for this misinformation and advise them that the advice they were giving was wrong. In addition, in response to the many repetitive procedural questions from ministers who were then under audit, Steve Gelb prepared a form letter for Mr. DeMarco's signature that described the procedural steps that occur from the beginning of an audit of a tax return to the filing of a petition with the Tax Court. The record is unclear as to whether a copy of this letter was sent to every FCR minister or just to those ministers who were under an audit by the Internal Revenue Service.

In any event, petitioners received a copy of this letter, dated November 11, 1981, and signed by Mr. DeMarco. The letter was addressed to Mr. and Mrs. George Kitcher and was typed on

Mr. DeMarco's stationery. In addition to the procedural concerns, the letter also stated that any questions that arise should be directed in writing to Mr. DeMarco's office. In addition, the letter encouraged petitioners to execute a power of attorney to permit Mr. DeMarco's firm to receive all future communications directly from the Internal Revenue Service on their behalf. The record does not indicate whether petitioners executed such a power of attorney.[8]

Except for wrapping up some loose ends, Mr. DeMarco ceased representing the FCR on a regular basis in December of 1982. Within this same time frame, Steve Gelb left the employ of Mr. DeMarco, and an attorney named Kosarek replaced him. However, shortly thereafter, the FCR organized its own legal department, and Kosarek left Mr. DeMarco and became a member of the FCR's legal department. About this time, an attorney named James V. Tamburro also began working for the FCR's legal department.[9] The FCR's Legal Department and Mr. DeMarco's

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[8] We think it unlikely that petitioners executed such a power of attorney since the statutory notices of deficiency were mailed to petitioners and not to Mr. DeMarco.

[9] Petitioners offered, and we received into evidence, a form letter signed by James V. Tamburro that contained essentially the same information as Mr. DeMarco's form letter. The letter was typed on FCR stationery and the heading indicated it was issued from the FCR's Legal Department. This letter instructed ministers to direct any questions in writing to James V. Tamburro or Chester R. Kosarek. This letter was not addressed, but space was provided for inserting the name and address of an addressee.

(footnote continued)

office were located on different floors in the same building, but were wholly separate and independent of one another.

Petitioners filed their 1980 Federal income tax returns in accordance with the instructions provided by the FCR. On his 1980 Federal income tax return, Mr. Kitcher reported adjusted gross income in the amount of $30,959.68, his W-2 wages from the New York Telephone Company, but listed his occupation as "agent for church." On the Schedule A attached to his Form 1040, Mr. Kitcher reported charitable contributions in the amount of $31,000.07. These claimed charitable contributions, less the zero bracket amount, reduced his reported taxable income to an amount of $1,659.61. That effectively reduced his tax liability to zero and consequently, he claimed a total refund of the Federal income tax that had been withheld in the amount of $5,540.43. Attached to his 1980 tax return was a vow of poverty signed by Mr. Kitcher on December 17, 1980.

On her 1980 Federal income tax return, Mrs. Kitcher reported adjusted gross income in the amount of $21,939.61, her W-2 wages from the New York Telephone Company, but listed her occupation as "agent for church." On the Schedule A attached to her Form 1040, Mrs. Kitcher reported charitable contributions in the amount

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(footnote continued from previous page)

Mr. Kitcher testified that he received the Tamburro letter in late 1980 or early 1981, but we are satisfied that he is in error on the date. The FCR did not establish its Legal Department until after Mr. DeMarco ceased representing it, which was around December of 1982. The petition in this case was signed by Mr. Gelb, bore Mr. DeMarco's name and address, and was filed with the Tax Court on October 4, 1982. That occurred before the FCR set up its Legal Department.

of $25,518. These claimed charitable contributions, with or without the zero bracket amount, reduced her tax liability to zero, and consequently she claimed a total refund of the Federal income tax that had been withheld in the amount of $2,041.13. Attached to her 1980 tax return was a vow of poverty signed by Mrs. Kitcher on December 27, 1980. Attached to the returns of both spouses were receipts of purported cash contributions to the FCR, in each instance totalling at least the amount of each spouse's total W-2 wage income. Neither Mr. Kitcher nor Mrs. Kitcher claimed the initial $5,100 payment to the FCR as a deduction in determining each spouse's 1980 tax liability. Moreover, petitioners never filed an amended return claiming the $5,100 deduction.

By a statutory notice of deficiency dated July 7, 1982, respondent determined that the amount of $31,000 claimed by Mr. Kitcher on his 1980 Federal income tax return as a charitable contribution deduction did not qualify as a charitable contribution under the Internal Revenue Code. By a statutory notice of deficiency dated July 7, 1982, respondent determined the amount of $25,518 claimed by Mrs. Kitcher on her 1980 Federal income tax return as a charitable contribution deduction did not qualify as a charitable contribution under the Internal Revenue Code. In determining Mr. Kitcher's tax liability, respondent allowed him the standard deduction or zero bracket amount, and also allowed him two $1,000 exemptions, a personal exemption for himself and a dependency exemption for his son. In determining

Mrs. Kitcher's tax liability, respondent allowed her the standard deduction or zero bracket amount, and also allowed her a $1,000 personal exemption. The deficiency for each spouse was computed using rates for a married person filing separately.

Petitioners forwarded all the correspondence that they received from the Internal Revenue Service, including the notices of deficiency, to Mr. DeMarco's office. In response to these statutory notices, Steve Gelb, while working for Mr. DeMarco, timely filed a petition on October 4, 1982, with the Tax Court on petitioners' behalf. The petition challenged respondent's disallowance of the charitable contribution deductions and the additions to tax for negligence. Mr. DeMarco did not bill petitioners in connection with filing the Tax Court petition but was purportedly paid by the FCR. Except for filing the petition and a request for place of trial, neither Mr. DeMarco and Steve Gelb nor any other attorney for the FCR made any other appearances on record or took any other action in this proceeding on petitioners' behalf. Petitioners were represented at the trial by their present attorney whom they had retained for that purpose.

At some point after the filing of the petition and prior to trial, petitioners for the first time raised the issues for decision in this case. By stipulation, petitioners conceded the correctness of respondent's disallowance of the charitable contributions deductions and also conceded that the negligence addition under section 6653(a) is applicable to any deficiency.[10] Respondent conceded that the new issues were raised in the Tax Court sufficiently early and those issues were thus tried by agreement of the parties.

OPINION

1. Joint Filing Status

Petitioners filed separate Federal income tax returns (Forms 1040) for the 1980 taxable year and claimed "married filing separately" as their filing status. Petitioners were husband and wife at the close of the 1980 taxable year and could have filed a joint return for that year under section 6013(a) had they timely elected to do so. Each petitioner received a statutory notice of deficiency dated July 7, 1982, for the 1980 taxable year. In response to these statutory notices, a petition was timely filed on October 4, 1982, with the Tax Court on petitioners' behalf.

Having chosen initially to file separate returns, as petitioners did here, taxpayers have the privilege to switch to joint filing status. Section 6013(b)(1) provides in pertinent part that:

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[10] We have decided numerous cases involving ministers of the FCR attempting to avoid taxes by claiming sham charitable contributions or by claiming tax-exempt status under the guise of a vow of poverty. See generally Venni v. Commissioner, T.C. Memo. 1984-17; Makkay v. Commissioner, T.C. Memo. 1984-16; Poldrugovaz v. Commissioner, T.C. Memo. 1984-15; Keifer v. Commissioner, T.C. Memo. 1983-627; Lynch v. Commissioner, T.C. Memo. 1983-537; Stojalowsky v. Commissioner, T.C. Memo. 1983-236; Noberini v. Commissioner, T.C. Memo. 1983-49; Ocejo v. Commissioner, T.C. Memo. 1983-48.

> Except as provided in paragraph (2), if an individual has filed a separate return for a taxable year for which a joint return could have been made by him and his spouse under subsection (a) and the time prescribed by law for filing the return for such taxable year has expired, such individual and his spouse may nevertheless make a joint return for such taxable year. * * *

However, this switching privilege is sharply limited by section 6013(b)(2). As pertinent to this case, section 6013(b)(2) provides that:

> The election provided for in paragraph (1) may not be made--
>
> * * *
>
> (C) after there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 6212, if the spouse, as to such notice, files a petition with the Tax Court within the time prescribed in section 6213.

Petitioners never elected joint filing status at anytime prior to the mailing of the statutory notice of deficiency or prior to the filing of their petition in this Court. Thus section 6013(b)(2)(C) clearly precludes petitioners from electing joint filing status at this time.

Petitioners contend, however, that neither Mr. DeMarco nor Mr. Gelb advised them that filing a petition in the Tax Court would preclude the election of joint filing status. Assuming that to be the case, this Court cannot ignore or change the terms of the statute. Petitioners argue on brief that Mr. DeMarco was not counsel "of their own choosing, and his advice was apparently not upon the particular circumstances of the petitioners (Tr. 76, 77) but rather on the circumstances of what was best for the church." Petitioners have not established the factual predicate for their argument.[11] Having sought the benefits of this prepayment forum (the Tax Court), petitioners must accept any legal burdens or limitations incident to that choice.[12]

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[11] Mr. DeMarco's form letter to petitioners clearly outlined the IRS audit procedures and the benefits of filing a petition in the Tax Court once a statutory notice of deficiency was issued. That letter stated, inter alia, that the filing of such a petition

> can be accomplished without the taxpayer first having to pay the proposed income deficiencies. Most important, the IRS cannot pursue collection activity with respect to the alleged deficiency in income tax until a decision is entered by the Tax Court and all final appeals are either waived or denied by the higher courts.

The letter concluded by indicating that any questions should be directed in writing to Mr. DeMarco, Mr. Gelb, or Mr. Zeller. There is no indication that petitioners ever submitted any questions to Mr. DeMarco or his staff. When petitioners received the statutory notices, they mailed them to Mr. DeMarco's office for a petition to be filed on their behalf. Petitioners cannot now be heard to argue that Mr. DeMarco or Mr. Gelb was not counsel of their choice. Indeed if Mr. Gelb had not timely filed the petition, IRS would have assessed the deficiencies and begun collection of the tax. Moreover, petitioners' argument that their personal situation was not considered is not borne out by the record citation given in support thereof. While Mr. DeMarco had no personal knowledge about petitioners or the filing of their particular petition, he rejected the suggestion of petitioners' counsel that such petitions were automatically filed once the statutory notices were sent to his office. Mr. DeMarco responded:

> Well, not at that point. I mean I hope that wasn't always done. I mean, I imagine Steve [Gelb] or Harvey [Zeller] spoke to these people before he did that and went over the situation before that was done. I mean I don't know in every case. Nor do I know on this case.

Steve Gelb, with whom Mr. Kitcher admittedly talked, did not testify at the trial. The record does not indicate what Mr. Gelb told Mr. Kitcher. More importantly, the record does not indicate what, if anything, Mr. Kitcher asked Mr. Gelb. There is no indication in the record that petitioners ever sought any legal advice about their filing status or anything else.

Petitioners nonetheless urge us in the interest of justice not to further penalize them for "the improper advice" of their former counsel[13] but to allow them to elect joint filing status for the 1980 taxable year. Petitioners are not so much asking for equitable[14] relief as they are asking us to disregard or ignore the clear mandate of the statute. This we cannot do.

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[12] Of course, even if petitioners had paid the tax and pursued the refund route in their local Federal District Court or in the United States Claims Court, any election of joint filing status would still have had to be made before they "commenced a suit in any court for the recovery of any part of the tax for such taxable year." Sec. 6013(b)(2)(D). Jacobson v. Commissioner, 73 T.C. 610, 614 (1979). In other words, there is a cut off for the switching privilege in any event. The cut off point is slightly different depending on the court in which suit is brought. The mailing of the statutory notice of deficiency is the cut off point if the taxpayer wishes to pursue the deficiency route (prepayment forum, i.e., the Tax Court). Sec. 6013(b)(2)(C). The filing of the refund suit is the cut off point if the taxpayer wishes to pursue the refund route (Federal District Court or Claims Court). Sec. 6013(b)(2)(D). Whether petitioners would have been willing to give up their right to litigate in a prepayment forum, to pay the tax, and then to bring a refund suit just to gain some additional time (between issuance of the statutory notice and filing of the refund suit) to make their election for joint filing status is problematical. In view of the litigating position petitioners were espousing until just shortly before the trial in this Court and in view of the fact that joint filing status was an issue raised at the eleventh hour, we rather doubt petitioners would have decided to forego the benefits of a prepayment forum. Petitioners are wholly silent as to this very practical dollars and cents matter.

The clear, unambiguous statutory language of section 6013(b)(2)(C) precludes the election of joint filing status after a notice of deficiency has been mailed to either spouse if a petition, in response to such notice, is timely filed with the Tax Court. Thompson v. Commissioner, 78 T.C. 558, 561 (1982); Richardson v. Commissioner, 72 T.C. 818, 826 (1979). Even if petitioners had tried to elect joint filing status between the date of the mailing of the statutory notice and the filing of the petition, it would have been too late. Under section

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[13] There is no evidence in the record that petitioners were given any "improper" legal advice. See nn. 11 and 12, supra. At best there is a suggestion that petitioners were not told the legal ramifications of their initial choice to file separate returns, namely, that the privilege to switch to joint filing status was not unlimited and that there were cutoff points for such a switch. Once the statutory notices were mailed to petitioners and before petitioners sent those notices to Mr. DeMarco's office, it was already too late to elect joint filing status if petitioners wanted to pursue the deficiency (prepayment) route. See nn. 11 and 12, supra.

[14] To the extent that petitioners are arguing for equitable relief, we are without authority to consider the matter. Pesch v. Commissioner, 78 T.C. 100, 130 (1982), citing Lorain Avenue Clinic v. Commissioner, 31 T.C. 141, 164 (1958). "The Internal Revenue Code, not general equitable principles, is the mainspring of [the Tax Court's] jurisdiction." Hays Corp. v. Commissioner, 40 T.C. 436, 443 (1963), citing Commissioner v. Gooch Co., 320 U.S. 418, 422 (1943).

6013(b)(2)(C), the timely filing of a petition with the Tax Court annuls any election of joint filing status, by formal amended return or otherwise, made after the date on which the notice of deficiency was mailed. Druker v. Commissioner, 697 F.2d 46, 52 (2d Cir. 1982), affg. on this point 77 T.C. 867 (1981), cert. denied 461 U.S. 957 (1983); Jacobson v. Commissioner, 73 T.C. 610, 614 (1979). Since petitioners did not elect joint filing status prior to July 7, 1982, the filing of the petition with the Tax Court on October 4, 1982, precludes petitioners from electing joint filing status for the 1980 taxable year at this time.

Section 212(3) Deductions

Petitioners contend that at least fifty percent of the $5,100 they paid to the Freedom Church of Revelation (FCR) is properly deductible in 1980 under section 212(3) as an amount expended for tax advice and legal representation in contesting their tax liability.[15] Respondent argues that such amounts are not ordinary and necessary expenses and do not bear a reasonable or proximate relation to the determination of petitioners' tax liability and consequently, are not deductible under section 212(3). Respondent argues in the alternative that any portion of the $5,100 membership fee allocated for tax advice or legal representation in the Tax Court is attributed to services to be performed in the future and thus a capital expenditure that must be capitalized and therefore is not properly deductible in 1980. Moreover, respondent argues that even assuming some part of the $5,100 membership payment was expended for tax advice or legal representation, petitioners have failed to establish any reasonable basis for allocating any part of the $5,100 to these deductible items, and therefore, any deduction under section 212(3) must be denied.

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[15] At trial, petitioners contended that the entire $5,100 membership fee was expended for tax advice and legal representation and properly deductible under section 212(3). On brief, however, petitioners concede that intangible benefits were attached to the ministerial credentials they received, and petitioners arbitrarily attribute fifty percent of the $5,100 membership fee to these intangible benefits and conclude that the other fifty percent was expended for tax advice and legal representation in tax matters and therefore deductible under section 212(3).

Section 212(3) allows a deduction for all the ordinary and necessary expenses "paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax."[16] The regulations promulgated under this section provide in pertinent part that "expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible." Section 1.212-1(l), Income Tax Regs. Moreover, ordinary and necessary expenses paid for Federal income tax planning are generally deductible under section 212(3). Zmuda v. Commissioner, 79 T.C.

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[16] Petitioners have not raised and we need not consider any other basis for allowing the deduction. However, the facts show that the expenditure was not paid or incurred for the production or collection of income (sec. 212(1)) or for the management, conservation, or maintenance of any property held for the production of income (sec. 212(2)).

714, 725 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); *Merians v. Commissioner*, 60 T.C. 187 (1973); *Collins v. Commissioner*, 54 T.C. 1656 (1970).

Petitioners contend that in return for the required $5,100 membership fee which they paid to the FCR incident to becoming ministers therein, the FCR promised to provide them with tax advice and with legal representation in the event the Internal Revenue Service ever questioned the deductibility of their charitable contributions to the FCR. Petitioners conclude the amounts expended for these services are deductible under section 212(3). However, petitioners must prove that any payment was "ordinary and necessary" and expended for the purposes designated in section 212(3). *Professional Services v. Commissioner*, 79 T.C. 888, 919 (1982); Rule 142(a). We are not convinced the expense of $5,100 that petitioners incurred incident to becoming ministers in the FCR was in fact expended for any of the statutory purposes under section 212(3) or the regulations thereunder.

Except for the uncorroborated, self-serving testimony of both petitioners, which we are not required to accept, *Epp v. Commissioner*, 78 T.C. 801, 803 (1982), the record is singularly devoid of evidence as to any tax advice or legal representation that petitioners were entitled to receive or did receive in return for their $5,100 payment to the FCR. Petitioners offered no credible evidence to establish that the FCR was obligated to provide them with any tax advice or legal representation in return for their $5,100 payment.[17] Accordingly, we conclude that petitioners paid $5,100 to the FCR to become ministers therein, and they have completely failed to prove they expended any funds for a deductible purpose under section 212(3).[18]

Even assuming that the FCR was obligated to provide tax advice and legal representation in return for their $5,100 payment, petitioners would still bear the burden of proving that such services were actually rendered and these services were deductible items under section 212(3). Benningfield v. Commissioner, 81 T.C. 408, 422 (1983). Petitioners admit that they became ministers in the FCR for the purpose of eliminating their tax liability. Petitioners claim they attended an FCR meeting prior to joining the FCR and were told that becoming a minister in the FCR was a legal means to avoid all Federal and state taxes. In addition, upon joining the FCR, they were given a packet of materials that contained various Internal Revenue

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[17] Moreover, the record does not explain why the check in the amount of $5,100 was annotated as "Donation-Educational" if a portion was supposedly attributable to tax advice and legal representation. In addition, the record indicates that petitioners did not consider the $5,100 payment a deductible expense at the time they made the payment incident to becoming ministers in the FCR since neither petitioner treated the expense as a deductible item when computing their 1980 taxable incomes. See Mustain v. Commissioner, T.C. Memo. 1982-670.

[18] See Benningfield v. Commissioner, 81 T.C. 408, 422 (1983); Professional Services v. Commissioner, 79 T.C. 888, 917-920 (1982); Luman v. Commissioner, 79 T.C. 846, 855-860 (1982); Zmuda v. Commissioner, 79 T.C. 714, 724-725 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); Epp v. Commissioner, 78 T.C. 801, 803-807 (1982); Contini v. Commissioner, 76 T.C. 447, 453-455 (1981).

Service publications relating to the tax-exempt status of churches and clergy members in general. They also received a copy of the determination letter dated June 8, 1979, issued by the Internal Revenue Service, that stated the FCR of Hohokus, New Jersey was exempt from Federal income tax under section 501(c)(3). Petitioners also received copies of tax returns that ministers in the FCR had filed in previous years. The returns indicated that these ministers were tax-exempt and were entitled to a refund of previously withheld Federal income taxes. Petitioners argue that these documents reinforced and fostered their belief that they had indeed stumbled upon a legal means to avoid taxes. These facts might be relevant to a negligence issue, were this not such a "pie-in-the-sky" scheme. These facts, do not establish that petitioners had paid for or received tax advice and legal representation.

However, petitioners argue that as ministers in the FCR, they attended various meetings where they received instructions in preparing the various tax forms they were required to file and other tax forms they were entitled to file as ministers in the FCR. Furthermore, petitioners also claim they received continuing instruction from the FCR on the organizational and operational aspects of their local chapter of the FCR in order to maintain their tax-exempt status. Petitioners contend the totality of these services represent deductible items under section 212(3). We think that it is significant that petitioners did not seek the advice of outside counsel prior to becoming ministers in the FCR. We conclude that the tax advice, which petitioners claim enticed them to become ministers in the FCR, consisted merely of unwarranted representations by other ministers in the FCR. The record does not indicate that any professional person, knowlegeable in the area of tax and competent and qualified to render tax opinions, represented to petitioners the validity of the purported scheme to avoid all taxes. Such advice and opinions came only from other FCR ministers.[19] In effect, the FCR or agents thereof merely promised petitioners a permanent tax avoidance plan in return for their initial investment of $5,100, and no reasonable person could have believed such a "pie-in-the-sky" scheme. Not to put too fine a point on the matter, what petitioners thought they were buying was freedom from all taxes, Federal and state, for the rest of their lives. Petitioners candidly testified that they thought the $5,100 was a good investment if they never had to pay any more taxes. Petitioners now acknowledge that this "pie-in-the-sky" scheme won't work, but they shamelessly ask the rest of the taxpaying public to share the expense of their failed tax avoidance scheme by trying to label the expense as a payment for tax advice and legal representation.

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[19] Mr. DeMarco was retained by the FCR as general counsel to defend the deductibility of church donations. However, Mr. DeMarco did not become involved with these tax matters of the FCR on a regular basis until May of 1981. This was almost a year after petitioners' $5,100 payment to the FCR on June 20, 1980. In addition, Mr. DeMarco became involved with the ministers' returns only in the event of an audit. Mr. DeMarco neither rendered an opinion to petitioners regarding the deductibility of their charitable contributions nor advised or instructed petitioners in the filing of their 1980 Federal income tax returns.

Moreover, the record indicates that any tax advice and instructions that petitioners received in preparing various tax returns at the various FCR meetings were rendered by ministers of the FCR. Although the record is unclear as to how many and which FCR meetings Mr. DeMarco attended, he did not advise or instruct petitioners in the filing of their 1980 tax returns and he did not recall anyone rendering such advice or instructions at any of the meetings that he attended. Petitioners were told that Joseph Coniglione, the head of the FCR, was an accountant by profession, and they filed their tax returns according to his instructions. We disregard this hearsay, and there is no probative evidence in the record to establish that Coniglione was in fact an accountant. Although we generally consider services of accountants deductible items if such services are within the scope of section 212(3), see Surloff v. Commissioner, 81 T.C. 210, 241 (1983), we conclude that any tax advice rendered by Joseph Coniglione or any instructions that he provided to petitioners in the filing of their income tax returns were self-serving, to say the least, and were rendered in his capacity as (footnote continued)

We have repeatedly sustained the section 6653(a) additions against taxpayers for negligence or intentional disregard of rules and regulations in cases involving purported charitable contributions to a "church" that simply constituted use of the funds for personal and family expenses. Davis v. Commissioner, 81 T.C. 806, 821 n. 12 (1983), affd. by unpublished opinion 767 F.2d 931 (9th Cir. 1985). In addition, in Miedaner v. Commissioner, 81 T.C. 272, 282 (1983), although we did not award damages, we made it crystal clear that claims with respect to

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(footnote continued from previous page)
the head of the FCR to further this blatant tax-avoidance scheme. In any event, based on the tax returns that petitioners filed for the year in issue, any tax advice and instructions that petitioners received at these FCR meetings in the preparation of their tax returns were totally unfounded and frivolous misrepresentations.

churches established solely for tax avoidance purposes are frivolous, and serious consideration will be given in the future to imposing damages against taxpayers under section 6673.

It would indeed be anomalous to allow a deduction under section 212(3) for amounts expended for any advice rendered by the FCR or representatives thereof that is totally unfounded and that espouses a position that we have repeatedly found to be both negligent and legally frivolous.[20] We conclude that petitioners have failed to prove that the services they purportedly received in the preparation of their tax returns are within the scope of section 212(3) or the regulations thereunder.

Finally, petitioners contend that at least the preparation and the filing of the petition in this case are deductible items under section 212(3). Petitioners sent the statutory notices of deficiency that they received from the Internal Revenue Service to Mr. DeMarco's office. Mr. DeMarco's office prepared and filed the petition in this case with the Tax Court on October 4, 1982. Mr. DeMarco did not bill petitioners for this service but was paid by the FCR. The fee for filing this petition with the Tax

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[20] We do not imply that simply "bad" tax advice rendered by attorneys or certified public accountants is a non-deductible item under section 212(3). See *Collins v. Commissioner*, 54 T.C. 1656 (1970); *Ippolito v. Commissioner*, T.C. Memo. 1965-167, affd. on another issue 364 F.2d 744 (2d Cir. 1966), cert. denied 385 U.S. 1005 (1967). But see *Crowder v. Commissioner*, T.C. Memo. 1984-543, on appeal (9th Cir., June 25, 1985), where we suggested that section 212(3) requires *legitimate* tax advice or tax planning.

Court was $60. Sec. 7451.[21] In addition, petitioners received a letter from Mr. DeMarco, dated November 11, 1981, that described the procedural steps that occur from the time of an audit to the filing of the petition with the Tax Court. Petitioners cite no authority that would allow a deduction in 1980 for amounts paid in such year for contingent legal services that might be performed in future years. Respondent argues that to the extent that a portion of the ministry fee paid in 1980 was for tax advice or legal representation in future years, such amounts must be capitalized and are not deductible in 1980.[22] Wildman v.

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[21] Sec. 7451. FEE FOR FILING PETITION.

> The Tax Court is authorized to impose a fee in an amount not in excess of $60 to be fixed by the Tax Court for the filing of any petition for the redetermination of a deficiency or for a declaratory judgment under part IV of this subchapter or under section 7428 or for judicial review under section 6226 or section 6228(a).

We note that the fee for filing a petition with the Tax Court in the year that petitioners joined the FCR was $10.

Section 7451 was amended by striking out "$10" and inserting "$60," applicable to petitions filed after December 31, 1981. Economic Recovery Tax Act of 1981, Pub.L. 97-34, §751, 95 Stat. 349.

[22] At best, petitioners were entitled to legal representation only in the event the Internal Revenue Service questioned the deductibility of the charitable contributions to the FCR on their returns. Such services could have been performed only in years subsequent to 1980, and the cost of any such services was not ascertainable in 1980.

Although petitioners have not established an ascertainable fair market value of Mr. DeMarco's services, we conclude that the

(footnote continued)

Commissioner, 78 T.C. 943, 957-962 (1982); *Estate of Boyd v. Commissioner*, 76 T.C. 646, 664-668 (1981). We agree with respondent. Consequently, even if a portion of the $5,100 payment to the FCR could be deemed to be allocable to services performed after the year in issue, we conclude that such amount would not be properly deductible in 1980.

In any event, even if part of the $5,100 to the FCR could be deemed to have been made for tax advice and legal representation within the scope of section 212(3), the record is devoid of any rational basis on which we could allocate any portion of the payment to such purposes. Cf. *Merians v. Commissioner*, 60 T.C. 187 (1973). Petitioners have the burden of proving what portion, if any, of such payment was paid for deductible items. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933). When a taxpayer proves that some part of an expenditure was made for deductible purposes and when the record contains sufficient evidence for us to make a reasonable allocation, we will do so. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). However, the record in this case provides absolutely no basis for making such an allocation. Under such circumstances, a deduction based on the *Cohan* rule would be "unguided largesse." *Williams v. United States*, 245 F.2d 559, 560 (5th Cir. 1957); see *Gran v.*

(footnote continued from previous page) value of such services is at best de minimis. The cost of filing a petition with the Tax Court at the time petitioners paid the $5,100 to the FCR was $10. See n. 21, *supra*. In addition, except for filing the petition in this case and requesting a place for trial, Mr. DeMarco's firm made no other appearances on record and took no other action on petitioners' behalf.

Commissioner, 664 F.2d 199 (8th Cir. 1981), affg. per curiam a Memorandum Opinion of this Court. Accordingly, we hold that petitioners are not entitled to any deduction under section 212(3) in connection with the $5,100 payment to the FCR.

To reflect the foregoing,

Decision will be entered under Rule 155.

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T. C. Memo. 1986-42

UNITED STATES TAX COURT

PETER J. BRALLIER, ET AL.,[1] Petitioners *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 12982-82, 13096-82, 21352-83, 21353-83. Filed January 29, 1986.

B was the sole shareholder and manager of Nor-Pen, a corporation which owned and operated five Round Table pizza restaurants in San Mateo County, California. Nor-Pen claimed advertising deductions under section 162(a), I.R.C. 1954, in connection with automobile racing performed by B and paid for by Nor-Pen. *Held*, the racing expenses are allocated between advertising expenses deductible by Nor-Pen and nondeductible expenditures imputed to B as constructive dividends. *United States v. Haskel Engineering & Supply Company*, 380 F.2d 786 (9th Cir. 1967), and *Palo Alto Town & Country Village, Inc. v. Commissioner*, 565 F.2d 1388 (9th Cir. 1977), affg., revg. and remanding T.C. Memo. 1973-223, followed. *Held further*, amount of allowable miscellaneous business deductions determined. *Held further*, B is liable for the late filing addition to tax under section 6651(a)(1), I.R.C. 1954, with regard to his 1976 return.

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[1] Cases of the following petitioners are consolidated herewith: Nor-Pen Investment Co., Inc., docket Nos. 13096-82 and 21352-83; and Peter J. Brallier, docket No. 21353-83.

ORIGINAL

Martin A. Schainbaum, Kathleen A. Miller and John D. Garvic, for the petitioners.

Alan S. Beinhorn and Paul J. Krug, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

NIMS, Judge: In these consolidated cases, respondent determined the following deficiencies:

Peter J. Brallier

Calendar Year	Income Tax	Addition to Tax Section 6651(a)(1)[2]
1975	$35,531.00	-
1976	49,523.75	$9,904.75
1980	49,229.00	-
1981	41,947.00	-

Nor-Pen Investment Company, Inc.

Fiscal Year Ended	Income Tax
3-31-75	$26,977.84
3-31-76	48,148.57
3-31-77	29,750.62
3-31-80	35,083.00
3-31-81	26,994.00

The issues for decision are as follows: (1) whether, and to what extent, Nor-Pen Investment Company, Inc. (Nor-Pen) is entitled to deductions for expenses and depreciation relating to automobile racing by its sole shareholder, Peter J. Brallier (Brallier) under sections 162 and 167; (2) whether expenses incurred by Nor-Pen for Brallier's automobile racing constituted constructive dividend income to Brallier; (3) whether the delinquent filing of Brallier's income tax return for the year 1976 was due to reasonable cause and not due to willful neglect; (4) whether payments made on March 31, 1975, totalling $4,730 by Nor-Pen to Brallier's sons and daughters and deducted by Nor-Pen as contract hire on its return for the fiscal year ended March 31, 1975, are ordinary and necessary business expenses deductible under section 162; (5) whether a payment in the amount of $1,100 made by Nor-Pen for rent of a condominium apartment is deductible by Nor-Pen for the fiscal year ended March 31, 1975, as an ordinary and necessary business expense under section 162; and (6) whether the payment of $180 deducted by Nor-Pen on its return for the fiscal year ended March 31, 1975, for telephone expenses incurred in relation to the rental of property from Billings Interiors is an ordinary and necessary expense deductible under section 162.

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[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 in effect for the years in issue. All rules references are to the Tax Court Rules of Practice and Procedure.

Respondent concedes the deductibility of the payment to Brallier in the amount of $1,950 on behalf of Richard Volante.

Brallier, the petitioner in docket number 12982-82, has conceded certain other issues, except for the decrease in rental income. Resolution of this issue is dependent upon the Court's finding with respect to the constructive dividend issue.

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Nor-Pen, the petitioner in docket number 13096-82, has conceded certain other issues, except for the disallowance of a deduction for a net operating loss carried forward from the fiscal year ended March 31, 1973, to the fiscal year ended March 31, 1976. Resolution of this issue is dependent upon the Court's finding with respect to respondent's determination which increased Nor-Pen's taxable income for intervening years in an amount sufficient to absorb the entire loss.

The parties made the following stipulation: Respondent now concedes that for Brallier's calendar years, as set forth below, the amounts asserted as constructive dividends, which amounts were attributable to racing activities, are as follows:

	1980	1981
Advertising expense-Racing	$30,860.50	$ 832.65
Rent expense-Racing	1,332.00	1,332.00
Wage expense-Racing	168.30	-0-
Insurance expense-Racing	-0-	-0-
Total	$32,360.80	$2,164.65

We construe the foregoing to mean that respondent is not asserting constructive dividend treatment against Brallier in excess of the amounts stated for 1980 and 1981.

The parties also made the following stipulation: The constructive dividend set forth in the notice of deficiency, upon which the case having docket number 12982-82 is based, if respondent prevails is reduced for the years 1975 and 1976 by the same ratio as the amount that total racing expenses have been reduced in the stipulation of facts bears to the total racing expenses set forth in the notice of deficiency.

Any adjustment required pursuant to the foregoing stipulation would be made in the Rule 155 computation.

Petitioners by stipulation have abandoned a statute of limitations issue raised in certain of their petitions.

FINDINGS OF FACT

Petitioner Peter J. Brallier (Brallier) resided in Hillsborough, California, at the time he filed his petitions in this case.

Petitioner Nor-Pen Investment Company, Inc. (Nor-Pen) had its principal place of business in San Mateo County, California, at the time it filed its petitions in this case.

During all of the years at issue, Brallier was president and sole shareholder of Nor-Pen.

Nor-Pen during the years at issue was the operator of five franchised Round Table Pizza establishments located at the following addresses:

a. 240 West Third Avenue, San Mateo, CA
b. 1207 Burlingame Avenue, Burlingame, CA
c. 2 West Hillsdale Blvd., San Mateo, CA
d. 1310 West Hillsdale Blvd. (Laurelwood Shopping Center), San Mateo, CA
e. 1070 Foster City Blvd. (Marlin Cove Shopping Center), Foster City, CA

Neither Brallier nor Nor-Pen has ever owned any shares of Round Table Pizza Corporation, Inc. (RTP) or Round Table Franchise Corporation (RTFC).

RTFC evolved from a pizza restaurant business founded by William R. Larson in December, 1959. RTFC and its predecessor have been granting Round Table Pizza Restaurant franchises since 1962, in California and in other States.

On January 16, 1979, RTP acquired RTFC's business and assets. At that time there were 140 units. At the time of trial there were 392 units located throughout the West and as far east as Iowa, Minnesota and Wisconsin.

Nor-Pen signed its first Round Table franchise agreement with RTFC on January 1, 1965. Subsequent agreements were signed on January 27, 1967, and December 9, 1974. The franchise agreements specify that advertising is for the benefit of all franchisees.

The average sales volume of RTFC's 140 units in 1979 was approximately $300,000 per year. For the years at issue, the 392 Round Table units yielded a combined gross revenue in the neighborhood of $160 million. The average sales volume per store per year was approximately $480,000.

Nor-Pen has never declared or paid a formal dividend.

During the relevant periods, RTFC maintained an advertising trust fund to which certain Round Table franchisees were required, by the terms of their franchise agreements, to contribute. The required contribution from November 30, 1968, to July 1, 1979, was one percent of gross sales. RTFC began signing franchise agreements requiring a three percent contribution to the advertising fund in 1977, but collected only one percent prior to July 1, 1979. An additional two percent was also expected to be spent by the franchisees on local advertising. On July 1, 1979, RTFC began collecting the three percent contribution from those franchisees whose franchise agreements so required. Nor-Pen pays to RTFC three percent of its gross sales as a franchise fee but does not pay into the advertising trust fund.

During the years at issue, Nor-Pen's local advertising consisted of newspaper advertising, "couponing", direct mail advertising, door-to-door hangers and sponsorship of local athletic teams. Richard Dumke, the president of RTFC during part of the relevant period, believed that petitioners' racing promotion activity had been of value in promoting and stimulating the name Round Table generally.

The following tables reflect the relationship of certain of Nor-Pen's advertising and racing expenditures to gross receipts for the years at issue, together with the amounts Nor-Pen would have been required to contribute to the advertising fund under RTFC's standard franchise agreement:

Fiscal Year Ended	Gross Receipts	Total Advertising & Racing Expenses	Total Advertising & Racing Expenses As A Percent of Gross Receipts	Three Percent of Gross Receipts
3-31-75	$1,144,807.39	$104,073.76	9.09	$34,344.21
3-31-76	1,202,374.44	108,746.33	9.04	36,071.22
3-31-77	1,272,947.78	79,143.93	6.22	38,188.44
3-31-80	1,751,389.24	98,355.95	5.62	52,541.67
3-31-81	1,954,089.31	106,379.72	5.44	58,622.67

Auto Racing

Fiscal Year Ended	Expenditures	Depreciation	Total	Total Racing Expenditures As A Percent of Gross Receipts
3-31-75	$62,519.31	$5,393.00	$67,912.31	5.93
3-31-76	65,138.71	5,194.00	70,332.71	5.85
3-31-77	49,220.00	2,876.00	52,096.00	4.09
3-31-80	34,273.50	-0-	34,273.50	1.96
3-31-81	26,901.11	-0-	26,901.11	1.38

The following table reflects Nor-Pen's auto racing expenditures as a percent of total advertising expenditures for the years at issue:

Fiscal Year Ended	Percent
3-31-75	65.25
3-31-76	64.68
3-31-77	65.82
3-31-80	34.85
3-31-81	25.29

Initial monies paid into the advertising trust fund were used by RTFC to create advertising books and materials. The books contained examples of advertisements and were distributed to the franchisees, including Nor-Pen, to aid them in their individual advertising. The advertising guidelines provided by RTFC suggested advertisements reflecting that pizza and sports activities such as football and baseball "go together." Nor-Pen utilized the pizza-and-sports go-together slogan suggested by the RTFC advertising guidelines, but also created "Pizza and Road Racing Go Together."

Brallier had an early interest in automobile racing. As a young boy he attended drag races and other forms of automobile racing. In the early 1960's, Brallier attended road races in Del Monte Forest, Indy car-type races at Sears Point and races in the Laguna Seca area, all in California.

In 1972, Brallier took a five-day course in race car driving at the Ontario Motor Speedway. Nor-Pen bought a used 1968 Corvette automobile in 1972 for about $2,500 and paid to have it modified to qualify for competitive racing. However, the engineering on the Corvette was not complete at the time Brallier entered race driving school, where he was required to furnish a racing car for training as a race driver. Nor-Pen therefore purchased a Pantera automobile through Brallier and had it modified for controlled race track driving for use by Brallier at the driver training course. Thereafter, further modifications were made to the Pantera to qualify it for competitive racing. Nor-Pen also purchased a truck on which to transport the race cars because it is illegal to drive race cars on city streets and freeways. The truck was also painted with and prominently displayed Round Table's logo and slogan and Round Table colors.

Brallier obtained personal satisfaction and accomplishment from automobile racing, which he found to be "really rewarding." It took his mind off business pressures and gave him a chance to work with his hands. Brallier personally drove the race cars in all of the races in which Nor-Pen race cars were entered, except one. In that race Brallier's co-driver crashed the car before Brallier got in any driving time, so the car, though entered, was not raced.

The following schedule shows the locations of races in which petitioners participated during the years in issue, the number of races entered at each location and the distances of such locations from the City of San Mateo, California (mileage to Seattle, Washington, and to Road America is not in the record):

Fiscal Year Ended	Location	No. of Races	Distance From San Mateo
3-31-75	Sears Point	5	55 miles
"	Laguna Seca	3	95 miles
"	Seattle, WA	1	826 miles
"	Riverside, CA	2	422 miles
3-31-76	Sears Point	2	55 miles
"	Laguna Seca	3	95 miles
"	Riverside, CA	1	422 miles
"	Seattle, WA	1	826 miles
"	Portland, OR	1	654 miles
"	Road America	1	2,175 miles
3-31-77	Sears Point	4	55 miles
"	Laguna Seca	3	95 miles
"	Ontario	1	410 miles
"	Road Atlanta	1	2,485 miles
"	Portland, OR	2	654 miles
3-31-80	Westwood, British Columbia	1	839 miles
"	Portland, OR	1	654 miles
"	Laguna Seca	1	95 miles
3-31-81	Riverside, CA	2	422 miles
"	Laguna Seca	1	95 miles

The following schedule shows the location of auto shows in which Nor-Pen's race cars were displayed during the years in issue, the number of auto shows entered at each location and the distance of each such location from San Mateo:

Fiscal Year Ended	Location	No. of Shows	Distance From San Mateo
3-31-76	Hillsborough Concourse	1	1.11 miles
"	Palo Alto Concourse	1	17.85 miles
"	San Mateo Auto Show	1	1.11 miles
3-31-77	Hillsborough Concourse	1	1.11 miles
3-31-80	Hillsborough Concourse	1	1.11 miles
3-31-81	Hillsborough Concourse	1	1.11 miles

Nor-Pen obtained sponsors for the race cars and displayed their names on the cars, the race car carrier, the driver's uniform and the shirts of the crew and the driver in exchange for the consideration indicated, as follows:

Name of Sponsor	Consideration
Union Oil	Gasoline
Goodyear Tire	Tires and Service
Champion Spark Plug	Spark Plugs and Information
Valv-O-Line	Oil
Metcalf Reis Lincoln	Use of Camper and Service
Al Leist Racing	Engine Repair
Budweiser	Beer

During the years in issue, Nor-Pen placed a substantial amount of advertising in The San Mateo Times (the Times), a newspaper which circulates throughout San Mateo County, Nor-Pen's area of operation. Depending upon the size, an individual ad costs from $100 to $500. These ads were placed in the Times through an advertising agency run by Lloyd Johnson, who also wrote a restaurant column called "Bright Lights" for the Times. Johnson made a practice of mentioning Times advertisers in his column, and these included Nor-Pen.

Nor-Pen's franchise agreements, as did the agreements of all other Round Table franchisees, contained a provision requiring the franchisees to promote the sale of, and stimulate interest in, pizza products and to favorably promote the name "Round Table Pizza Parlor" and "Round Table Pizza."

In general, the restaurant business and particularly the pizza restaurant business, in San Mateo County at least, is highly competitive. Petitioners perceive that people who attend athletic events are people who frequent pizza restaurants, and Nor-Pen's advertising was generally directed at that demographic segment of the population.

Petitioners' stores have been consistently successful Round Table franchises and have always been in the top 10 percent of all RTFC franchised stores.

During Nor-Pen's fiscal year ended March 31, 1975, Brallier made a series of trips to the "LA country area" where he looked around county by county to determine whether he wanted to transfer a substantial portion of his time and operations there. In this connection Nor-Pen expended $1,100 to rent a condominium apartment on a month-to-month basis. Telephone expenses were incurred in the amount of $180 in connection with Brallier's sojourn. Brallier gave up the idea of expanding his operations to southern California prior to March 31, 1975.

Nor-Pen paid the following amounts to Brallier's children during the fiscal year ended March 31, 1975:

Payee	Age	Amount
Michael	17	$ 980
Elizabeth	16	1,250
Julie	15	1,250
Bradley	7	1,200

None of the payments to Brallier's children were processed through Nor-Pen's normal payroll, nor were income and FICA taxes withheld. During 1975 Michael was employed by Nor-Pen in an undisclosed capacity. During the fiscal year ended March 31, 1975, Brallier's four children posed for a picture which was subsequently used in some of Nor-Pen's newspaper advertisements. The picture of Brallier's children replaced a picture of three smiling individuals in an advertisement supplied by the Round Table advertisement program.

Brallier obtained a three-month automatic extension of time within which to file his 1976 return, which extended the due date to July 15, 1977. The envelope in which Brallier's 1976 return was mailed to the IRS Service Center was postmarked October 14, 1977, and received there on October 18, 1977. Brallier mistakenly thought that he had an extension of time to October 15, 1977, since his California state income tax return was under extension to that date.

From October, 1973, to November, 1974, Nor-Pen owned a Cadillac automobile, for which expenses and depreciation were incurred and deducted by Nor-Pen on its tax returns. In November, 1974, Nor-Pen traded in its Cadillac for another Cadillac. From 1976 to the time of trial, Nor-Pen owned a Rolls-Royce four door sedan.

OPINION

Petitioner Peter J. Brallier (Brallier), during the years in issue, was the sole shareholder and chief executive of petitioner Nor-Pen Investment Co., Inc. (Nor-Pen), a corporation which owned and operated five pizza restaurants under the name "Round Table" in San Mateo County, California. Nor-Pen was a franchisee of Round Table Franchise Corporation (RTFC), itself a subsidiary of Round Table Pizza Corporation, Inc. (RTP). Neither Brallier nor Nor-Pen was a shareholder in either RTFC or RTP.

RTFC evolved from a pizza restaurant business founded by William R. Larson in December, 1959. RTFC and its predecessor have been granting Round Table Pizza Restaurant franchises since 1962, in California and in other states.

Nor-Pen signed its first Round Table franchise agreement with RTFC on January 1, 1965. Subsequent agreements were signed on January 27, 1967, and December 9, 1974. Each of the agreements required the franchisee to promote and stimulate the name Round Table Pizza. The franchise agreements specified that advertising is for the benefit of all franchisees.

Brallier has always been one of Round Table's most successful operators. During the years in issue, Nor-Pen's five restaurants were consistently in the top 10 percent of all RTFC's 392 franchises. RTFC maintained an advertising trust fund to which most of its franchisees were required to contribute. The amount of the required contribution was one percent of gross income until July 1, 1979, and three percent thereafter.

Although RTFC management persistently attempted to obtain Brallier's agreement to have Nor-Pen contribute to the advertising trust fund, Brallier just as persistently resisted making such contributions. Brallier prevailed, undoubtedly due to his consistently successful operation of Nor-Pen's franchises.

Brallier was not only a highly successful pizza restaurant operator, but he was also a dedicated racing car devotee. As a young boy, he attended drag races and other forms of automobile racing, and later he attended road races in Del Monte Forest, Indy car-type races at Sears Point and races in the Laguna Seca area, all in California. In 1972, Brallier took a five-day course in race car driving at the Ontario Motor Speedway. Brallier obtained personal satisfaction and accomplishment from automobile racing, which he found to be "really rewarding." It took his mind off business pressures and gave him a chance to work with his hands. With one minor exception, Brallier himself drove the race cars in all the races in which Nor-Pen's race cars were entered.

At some point Brallier's enthusiasm for automobile racing and his pizza restaurant operations coalesced. Nor-Pen acquired a Corvette and a Pantera, both of which were modified at Nor-Pen's expense for use in automobile racing. Nor-Pen also acquired a truck for transportation of the race cars to and from races, display purposes and the like. The race cars and the truck prominently displayed the Round Table logo, colors, etc. and Nor-Pen built a substantial part of its advertising around car racing.

There are several minor issues in this case which will be dealt with in due course. As to the main dispute, i.e., proper categorization of the race car expenditures, it is respondent's position that the costs incurred by Nor-Pen in connection with automobile racing are not ordinary and necessary business expenses of Nor-Pen but are constructive dividends to Brallier.

Petitioners counter by saying that the amounts spent by Nor-Pen for its race car activities were initially undertaken and subsequently pursued as an advertising and promotional endeavor for the benefit of Nor-Pen and are therefore deductible as ordinary and necessary business expenses under section 162(a). This being the case, the amounts spent by Nor-Pen are not constructive dividends to Brallier. At one point, in a single sentence on brief, petitioners also assert that if any part of the expenditures are not advertising-promotion expenses, then they are deductible as compensation to Brallier. Since petitioners nowhere else pursue this point, we conclude that it has been abandoned.

The burden is upon Nor-Pen to prove that the costs of car racing were ordinary and necessary to its pizza restaurant business and upon Brallier to prove that, to the extent if any that the automobile racing costs were not ordinary and necessary business expenses of Nor-Pen, they were nevertheless not constructive dividends. _Deputy v. du Pont_, 308 U.S. 488 (1940); Rule 142(a).

"Ordinary" has been interpreted to mean that the expense should have a reasonably proximate relation to the operation of Nor-Pen's business, _Challenge Manufacturing Co. v. Commissioner_, 37 T.C. 650 (1962), while "necessary" has been interpreted to mean helpful and appropriate in promoting and maintaining the trade or business. _Blackmer v. Commissioner_, 70 F.2d 255 (2d Cir. 1934), revg. a Memorandum Opinion of the Board of Tax Appeals. See _Lang Chevrolet Co. v. Commissioner_, T.C. Memo. 1967-212.

In general, allowable advertising expenses have been held to meet the above tests and therefore qualify as section 162 expenses. _Rodgers Dairy Co. v. Commissioner_, 14 T.C. 66 (1950); see generally _Lang Chevrolet Co. v. Commissioner_, _supra_.

With the above background we take as our texts the following holdings of the Ninth Circuit Court of Appeals (the court to which an appeal in this case would be taken):

> An expenditure may be, by its nature, ordinary and necessary, but at the same time it may be unreasonable in amount. In such a case only the portion which was reasonable would qualify for a deduction under § 162(a). * * *[_United States v. Haskel Engineering & Supply Company_, 380 F.2d 786, 788-789 (9th Cir. 1967).]

BEST [illegible]

--and--

> The test for constructive dividends * * * is two-fold; not only must the expenses be non-deductible to the corporation, but they must also represent some economic gain or benefit to the owner-taxpayer. * * * [Palo Alto Town & County Village, Inc. v. Commissioner, 565 F.2d 1388, 1391 (9th Cir. 1977), affg., revg. and remanding T.C. Memo. 1973-223; see also Falsetti v. Commissioner, 85 T.C. 332, 356-357 (1985).]

Petitioners rely heavily upon cases such as Sanitary Farms Dairy, Inc. v. Commissioner, 25 T.C. 463 (1955), and Rodgers Dairy Co. v. Commissioner, 14 T.C. 66 (1950), for the general proposition that the cost of unconventional forms of advertising--"unique and creative" to use petitioners' terms--may nevertheless be deductible. Sanitary Farms Dairy involved a big game hunt in Africa. Rodgers Dairy involved the exhibition of two Russian wolfhounds and show horses, with color coordinated horse blankets, stable drapes, equipment trucks and the like. But see Kenerly v. Commissioner, T.C. Memo. 1984-117, where we held that a taxpayer's Moorish castle was his home and not a deductible form of advertising.

Respondent asserts that petitioners have not provided any substantial evidence to show a causal relationship between Brallier's racing activity and Nor-Pen's pizza sales, relying on cases such as Challenge Manufacturing Co. v. Commissioner, 37 T.C. 650 (1962).

Applying Haskel Engineering, we conclude that the truth lies somewhere in between the two parties' positions.

As revealed through our findings of fact, the record to a certain extent supports petitioners' contention that the racing activities were a legitimate and useful, if somewhat unconventional, form of advertising. The race cars prominently displayed the Round Table colors and logo, and the race car theme was significantly played up in Nor-Pen's overall advertising. Nor do we totally agree with respondent that it is wholly detrimental to petitioners' case that the cars were raced at tracks which were a considerable distance from San Mateo. It must be assumed that race cars must be raced where there are tracks, and it would have appeared absurd for Nor-Pen to display the cars around San Mateo County to promote Nor-Pen's involvement in the sport of auto racing without also being able to display pictures, trophies and the like derived from actual races.

Having said that, we also recognize that there was a substantial element of personal satisfaction to Brallier connected with the racing activity. His enthusiasm for auto racing began when he was a young boy and continued unabated into his adult life. As the record before us shows, Nor-Pen bore the substantial costs of the racing activities. Without Nor-Pen, Brallier himself would have had to bear the entire cost of what can ony be described as an expensive hobby.

The fact that Brallier's hobby coincided with Nor-Pen's advertising would not necessarily be fatal to the deduction of all of the racing expenses were we not convinced that the amounts deducted were excessive in relation to the purpose served. United States v. Haskel Engineering & Supply Company, 380 F.2d at 788-789; cf. Lang Chevrolet Co. v. Commissioner, supra. Although Nor-Pen's operations were unquestionably successful, it must be recognized that insofar as that success resulted from advertising, Nor-Pen benefited not only from the racing advertising but also from the general promotion of Round Table by RTFC and its network of 392 franchisees, and from Nor-Pen's own local advertising, also substantial, through media other than car racing, e.g., newspaper ads, couponing, direct mail and the like.

While in absolute numbers the amounts spent by Nor-Pen for automobile racing might not strike one as excessive,[3] three countervailing considerations convince us that they are. First, Nor-Pen's racing costs have the characteristics of a national, or at least regional, advertising campaign. To the extent they are not excessive, they benefit all 140 or more RTFC franchisees, not simply Nor-Pen's five franchises in San Mateo County. See discussion, infra. And Nor-Pen expended substantial amounts over and above the racing expenses on purely local advertising, a tacit admission that the racing program alone was inadequate for this purpose.

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[3] Petitioners allege that some franchisees spent as much as 10 to 12 percent of gross sales for advertising, whereas Nor-Pen's averaged from 4 to 7 percent.

Second, the racing expenses substantially exceeded in three of the five years before us the three percent advertising trust fund contribution which RTFC's management deemed appropriate as a franchisee's contribution to chainwide advertising.

Third, as previously discussed, we are persuaded that there was a significant amount of personal gratification to Brallier inherent in the racing activity, not all the expenses of which a company not controlled by him would have incurred.

The task before us therefore comes down to a determination of the extent to which Nor-Pen's race car expenditures were incurred primarily to benefit Nor-Pen's trade or business and the extent to which the expenditures were primarily for the benefit of Nor-Pen's sole shareholder, Brallier.

Having denigrated to some extent respondent's argument that racing at distant locations invalidates an advertising expense deduction, we must nevertheless recognize that the argument does serve to introduce what we consider to be a significant weakness in petitioners' reliance upon *Sanitary Farms Dairy* and *Rodgers Dairy*. In those cases, where we found on facts peculiar to them that the expenditures primarily benefited the business corporate taxpayer, these were the *only* businesses benefited. That is not the situation before us.

While the record does not disclose the number of existing Round Table franchises when Brallier entered into his first franchise agreement in 1965, there were 140 units in January, 1979, and 392 units at the time of trial. We therefore think it fair to assume that in fiscal 1975, 1976 and 1977, the earliest years involved here, there were substantially more than five Round Table units in operation.

Nor-Pen's franchise agreements provided, as did the agreements of all other Round Table franchisees, that the franchisees would be required to promote the sale of, and stimulate interest in, pizza products and to favorably promote the name "Round Table Pizza Parlor" and "Round Table Pizza." The franchise agreements specify that advertising is for the benefit of all franchisees. Both past and present RTFC officers testified that Nor-Pen's methods of advertising, including car racing, satisfy Nor-Pen's contractual obligation to stimulate and promote the name Round Table and that such advertising activities were and are beneficial to RTFC. Petitioners themselves assert on brief that their racing promotion activities were a sufficient quid pro quo of advertising effort to satisfy the contractual commitment to promote and stimulate the name Round Table.

In addition to the racing expenditures, which benefited RTFC and its franchisees generally, Nor-Pen also spent considerable amounts on strictly local advertising. This included newpaper ads, "couponing", direct mail advertising, door-to-door hangers and sponsoring local athletic teams.

We think a fair inference may be drawn from the testimony of the RTFC officers, past and present, who testified at the trial that RTFC accepted Nor-Pen's racing expenses as a reasonable substitute for Nor-Pen's refusal to contribute to the advertising trust fund. Therefore, we consider it appropriate to allocate the racing expenditures between deductible and non-deductible amounts on the same basis as that upon which Nor-Pen would have made contributions to the RTFC advertising trust fund; except, however, we believe a three percent of gross receipts contribution would have been reasonable for the years involved herein. We accordingly hold that Nor-Pen may deduct, as advertising expenses under section 162(a), those race car expenditures in the years at issue which are equal to the lesser of three percent of gross receipts, or racing amounts actually incurred or expended.

While it is true that RTFC did not enforce the three percent contribution until July 1, 1979, Larson testified that franchisees were expected to expend an additional two percent of gross receipts on local advertising. Since all advertising by all franchisees was considered to be inter-beneficial to franchisees throughout the RTFC chain, we think there is a sufficient inherent mutual benefit gained from such advertising to permit its deduction. The balance of the racing expenditures in fiscal years 1975, 1976 and 1977, i.e., those in excess of three percent of gross receipts, we hold to be excessive and therefore non-deductible. United States v. Haskel Engineering & Supply Company, 380 F.2d at 788-789. The entire amount of racing expenses in fiscal years 1980 and 1981 are deductible by Nor-Pen since they are less than three percent of gross receipts.

This leaves the question of whether and to what extent the excess racing expenditures constitute dividends to Brallier. Applying the above-quoted rule of the Ninth Circuit--see Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d at 1391--we must determine whether and to what extent the expenditures held excessive under the rationale of Haskel Engineering "also represent some economic gain or benefit to the owner-taxpayer." We observe at this point that no formal dividend has ever been paid by Nor-Pen.

As the Palo Alto Town & Country Village rule indicates, disallowed expenses are not automatically taxable to the owner-shareholder. Ashby v. Commissioner, 50 T.C. 409 (1968), illustrates an application of this rule. In Ashby, we held that a majority shareholder would not be taxed under the constructive dividend rationale on the entire amount of corporate entertainment expenses disallowed to the corporation for failure to substantiate the expenses under section 274(d).

While we recognize that no money or property was directly transferred to Brallier in this case, nevertheless an economic benefit was conferred upon him by Nor-Pen in the form of the racing costs incurred for his, Brallier's, personal benefit. Unlike the situation in Palo Alto Town & Country Village, where "many of the country club expenses were incurred by others than taxpayers," 515 F.2d at 1391, Brallier was the sole beneficiary of the nondeductible racing expenditures incurred by Nor-Pen. There is simply no logical basis upon which a lesser amount could be imputed to him.

The regulations provide in section 1.301-1(c), Income Tax Regs., that "[s]ection 301 [relating to taxable corporate distributions] is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such." Examples of exceptions would be repayment of shareholder loans, compensation for service, payments to shareholder-vendors and rent. See discussion in 3 Bittker, Federal Taxation of Income, Estates and Gifts, par. 92.2, p. 92-13 (1981 ed.). Petitioners have not shown that any comparable exceptions apply here. The parties stipulated that Nor-Pen had sufficient earnings and profits to pay constructive dividends in the amounts set forth in the notice of deficiency (which amounts have been reduced by stipulation (see discussion at p. 4, supra). Furthermore, Brallier has not shown that the benefits conferred upon him by Nor-Pen had a fair market value less than the racing amounts expended by Nor-Pen. See Ashby v. Commissioner, supra, at 418; see also Challenge Manufacturing Co. v. Commissioner, supra. Accordingly, we hold that to the extent the racing expenditures incurred by Nor-Pen and deducted by it under section 162(a) have been found to be excessive, they are taxable to Brallier as constructive dividends. These amounts will, of course, be limited if so required by the stipulation entered into by the parties limiting the amounts of such dividends.

Nor-Pen rented an apartment in Beverly Hills, California, for the months of February and March, 1975, at the rate of $550 per month. The apartment was used by Brallier. Nor-Pen deducted $1,100 as rental expense on its return for the fiscal year ended March 31, 1975. Brallier testified that his business purpose in Los Angeles was to study the possibilities of engaging in another venture for Nor-Pen. His testimony on this issue was vague and general. Petitioners offered no documentary evidence to substantiate Nor-Pen's business purpose of this rental expense. Brallier's testimony was totally uncorroborated. In the stipulation of facts, respondent conceded that the amount deducted was in fact expended but did not concede that it was an ordinary and necessary business expense of Nor-Pen. Petitioners have the burden of proving the merits of their claim and of overcoming the presumption of correctness which attaches to respondent's determination. Rule 142(a). In Nelsen v. Commissioner, a Memorandum Opinion of this Court dated March 22, 1948, we made the following observation:

> We are asked to accept this testimony of an interested witness as proof of payments. Without being supported or corroborated by any other evidence, it is not enough to overcome the presumption that the respondent's determination is prima facie correct. The effect of the testimony of petitioner here is a conclusion, given without any circumstances to gauge its accuracy. See Easton v. Bryant, 19 Fed. (2d) 857; Birnbaum v.

> Commissioner, 117 Fed. (2d) 395; Hoefle v. Commissioner, 114 Fed. (2d) 713; Hiram C. Wilson, supra [17 B.T.A. 976].
>
> The evidence submitted here goes no further in proving petitioner's case than a signed statement by petitioner in his income tax return or in his claim for refund. * * *

We think these comments are equally appliable here. The only documentary evidence submitted in connection with this issue was a "Proposal for Round Table Franchise Corporation Sub-Franchise Agreement," which was offered into evidence by respondent and received by the Court. This proposal was for the development of Round Table Pizza locations in southern Calilfornia, Arizona and Nevada. Nor-Pen was not a party to this agreement. Rather, the proposal included the formation of a new corporation to be owned by Brallier, William Larson and another individual. Brallier's trip to southern California would be consistent with exploration of this proposal. His testimony that the trip to Los Angeles was on behalf of Nor-Pen rather than on his own behalf lacks credibility in light of the agreement. Expenditures incurred by a corporation on behalf of its sole shareholder are not deductible by the corporation. American Properties Inc. v. Commissioner, 28 T.C. 1100 (1957), affd. 262 F.2d 150 (9th Cir. 1958).

Respondent disallowed telephone expenses totalling $180 deducted by Nor-Pen on its March 31, 1975, return because petitioners did not establish that these were ordinary and necessary business expenses of Nor-Pen. Respondent's determination bears the presumption of correctness. Rule 142(a). Brallier's unsupported testimony regarding these telephone expenses is insufficient to overcome this presumption of correctness. Brallier testified as follows:

> Q. Did you also incur $180.00 in telephone expenses from the Los Angeles area during that period of time?
>
> A. Yes.
>
> Q. And what was the purpose of this telephone expense?
>
> A. Well, I mean, the arrangement that I had made with Mrs. Billings was that any phone bill would be in excess of the rental that I paid for the unit, so I owed her the money.

Petitioners offered no evidence to show the business purpose of the telephone calls made from the apartment. The deduction is therefore disallowed.

During its fiscal year ended March 31, 1975, Nor-Pen made the following payments to Brallier's children:

Payee	Age	Amount
Michael	17	$ 980
Elizabeth	16	1,250
Julie	15	1,250
Bradley	7	1,200

Nor-Pen deducted the payments as "bonuses." They were not processed through Nor-Pen's normal payroll nor were income and FICA taxes withheld. Respondent conceded on brief that Brallier's 17-year old son, Michael, worked for Nor-Pen and that Brallier's four children posed for a picture which was subsequently used in some of Nor-Pen's newspaper advertisements.

Aside from some generalized testimony by Brallier about "odd jobs", the record is silent as to any actual services which the children might have performed other than posing for the picture. Since respondent concedes that Michael did some work for Nor-Pen, we allow a deduction of $100 for these services plus $100 for posing for the picture. We also allow $100 for each of the other three children for the picture.

The Commissioner asserted the late filing addition to tax against Brallier with regard to his 1976 Federal income tax return.

Section 7502(a)(1) provides that a return received after the due date shall be deemed filed on the date of the U.S. postmark. However, section 7502(a)(2) provides that:

> This subsection shall apply only if--
>
> (A) the postmark date falls within the prescribed period or on or before the prescribed date--
>
> (i) for the filing (including any extension granted for such filing) of the return * * *

The due date of Brallier's return for the calendar year 1976 was July 15, 1977, as extended under a valid request for an extension of time. The date of the U.S. postmark on the envelope in which that return was mailed, October 14, 1977, did not fall within the prescribed period for filing the return as extended. Therefore, the postmark date is not to be deemed the filing date. See Rev. Rul. 73-133, 1973-1 C.B. 606.

The filing date is the date the return was received by the Internal Revenue Service Center, October 18, 1977. That date was three months and a fraction after July 15, 1977, the extended due date. See section 301.6651-1(b)(2), Proced. & Admin. Regs.

Brallier's explanation for the late filing of this return is that he had been granted an extension of time to file his state income tax return which extended the due date of that return to October 15, 1977, and he "mistakenly thought both extensions were good until October 15, 1977." Section 6651(a)(1) imposes an addition to tax of five percent per month or fraction thereof for the late filing of an income tax return, "unless it is shown that such failure is due to reasonable cause and not due to willful neglect." Section 301.6651-1(c)(1), Proced. & Admin. Regs., provides the following definition of "reasonable cause":

> If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause. * * *

A mistaken belief as to the correct filing date is not reasonable cause for late filing. American Milk Products Corporation v. United States, 41 F.2d 966 (Ct. Cl. 1930); see Board of Trade, Inc. v. Commissioner, T.C. Memo. 1969-58, and Aptitude Associates, Inc. v. Commissioner, T.C. Memo. 1962-281.

To reflect the foregoing and various concessions,

Decisions will be entered

under Rule 155.

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COMPLETED
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T. C. Memo. 1986-43

UNITED STATES TAX COURT

REINALDO MOURIZ AND MARIA E. MOURIZ, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 32259-83. Filed January 29, 1986.

Over a period of 6 months in 1979 and 1980, petitioner-husband engaged in six currency transactions in which he received an aggregate of $439,988 in small-denomination bills. None of this money was reported on petitioners' joint tax returns. Also, other income was omitted for 1980.

Held: (1) Respondent has proven fraud by clear and convincing evidence as to petitioner-husband for 1979 and 1980, and as to petitioner-wife for 1980. Additions to tax imposed. Sec. 6653(b), I.R.C. 1954.

(2) Respondent has failed to carry his fraud burden of proof as to petitioner-wife for 1979.

(3) Petitioners have failed to carry their burden of proof as to the deficiencies for 1979 and 1980.

ORIGINAL

Luis Medina, for the petitioners.

John F. Hernandez, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, Judge: Respondent determined deficiencies in Federal individual income taxes and additions to tax under section 6653(b)[1] (fraud) as follows:

Year	Deficiency[2]	Addition to Tax--Sec. 6653(b)
1979	$ 91,102.70	$47,646.85
1980	131,520.25	65,760.13

After concessions by both sides, the issues for decision are as follows:

(1) Whether each of the petitioners is liable for an addition to tax under section 6653(b) for each of the years in issue; and

(2) How much, if any, of the $229,997 and $209,991 that petitioner-husband received from certain banks in 1979 and 1980, respectively, is includible in petitioners' income for these years.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

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[1] Unless indicated otherwise, all section and chapter references are to sections and chapters of the Internal Revenue Code of 1954 as in effect for the years in issue.

[2] Of these amounts, self-employment taxes under chapter 2 are $607.70 for 1979 and $363.25 for 1980; the remaining amounts are chapter 1 income tax.

When the petition was filed in the instant case, petitioners Reinaldo Mouriz (hereinafter sometimes referred to as "Reinaldo") and Maria E. Mouriz (hereinafter sometimes referred to as "Maria"), husband and wife, resided in Miami, Florida.

1979 Tax Return

Petitioners filed their 1979 tax return on October 15, 1980. To the tax return there was attached a Form 4868, Application for Automatic Extension of time to File U.S. Individual Income Tax Return. On the Form 4868, dated April 14, 1980, petitioners stated that they expected not to owe any income tax for 1979. The purpose of the Form 4868 was to secure for petitioners a 2-month extension of time, until June 15, 1980, to file the 1979 tax return. To the tax return there also was attached a Form 2688, Application for Extension of Time to File. On the Form 2688, dated June 10, 1980, petitioners asked for an extension of time until August 15, 1980, to file the 1979 tax return, and stated that "Additional time is necessary as the accountant has not completed analyzing all distributions the taxpayer received from domestic and foreign entities."

On their 1979 tax return, petitioners reported income in the amounts and from the sources indicated in table 1.

Table 1

Amount	Source
$ 9,710	Wages--Maria--Roche Clinical Labs, Inc.
10,200	Wages--Reinaldo--Diaz Marble Co., Inc.[3]
187	Interest
1,878	Rent, royalty income
5,200	"Miscellaneous"[4]
$27,175	

On their 1979 tax return, petitioners reported a chapter 1 income tax liability of $3,770 (determined by use of income averaging), a chapter 2 self-employment tax liability of $421, a total liability of $4,191, a withholding credit of $2,325, and a balance due of $1,866.

Petitioners' 1979 tax return was prepared by Wilfred Braceras (hereinafter sometimes referred to as "Braceras"), who enquired into both petitioners' sources and amounts of income and included on the tax return all such information provided by petitioners. Any information included or excluded from the tax return was so treated by Braceras with petitioners' express knowledge and consent.

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[3] Reinaldo was a one-third owner of Diaz Marble Co., Inc., where he was employed as an appraiser or job estimater. Diaz Marble Co., Inc., went out of existence in 1981.

[4] The $5,200 "miscellaneous" item is not further described on petitioners' 1979 tax return, except that it also appears on Schedule SE as net earnings from nonfarm self-employment of Reinaldo.

1980 Tax Return

Petitioners filed their 1980 tax return on October 15, 1981. To the tax return there was attached a Form 4868. On the Form 4868, dated April 10, 1981, petitioners stated that they expected not to owe any income tax for 1980. The purpose of the Form 4868 was to secure for petitioners a 2-month extension of time, until June 15, 1981, to file the 1980 tax return. To the tax return there also were attached two Forms 2688. On the first Form 2688, dated June 15, 1981, petitioners asked for an extension of time until August 15, 1981, to file the 1980 tax return and stated that "Additional information is being forwarded to the return preparer so that a proper and complete return may be filed." On the second Form 2688, dated August 13, 1981, petitioners asked for an extension of time until October 15, 1981, to file their 1980 tax return and stated that "Additional information is still being accumulated and researched by the taxpayer to be forwarded to the return preparer to enable the return preparer to file a proper and complete return."

On their 1980 tax return, petitioners reported income in the amounts and from the sources indicated in table 2.

Table 2

Amount	Source
$16,218	Wages--Reinaldo
144	Interest
(22)	Rent, royalty income
5,200	"Miscellaneous" (see n.4, *supra*)
$21,540	

On their 1980 tax return, petitioners reported a chapter 1 income tax liability of $2,583, a chapter 2 self-employment tax liability of $421, a total liability of $3,004, a withholding credit of $1,882, and a balance due of $1,122.[5]

Petitioners' 1980 tax return was prepared by Edward Guttenmacher (hereinafter sometimes referred to as "Guttenmacher"), who enquired into both petitioners' sources and amounts of income and included on the tax return all such information provided by petitioners. Any information included on or excluded from the tax return was so treated by Guttenmacher with petitioners' express knowledge and consent.

Currency Transactions

Reinaldo engaged in the currency transactions described in table 3.

Table 3

Date of check/ transaction	Drawer of check	Amount of check
Sep. 12/13, 1979	Banco Immobilario, S.A.	$100,000
Sep. 27/27, 1979	Banco Immobilario, S.A.	100,000
Dec. 6/18, 1979	The Bank of Miami	29,997
	1979 Total	$229,997

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[5] To their 1980 tax return, petitioners attached a Form 2210, Underpayment of Estimated Tax by Individuals, showing a "penalty" (evidently, this is an addition to tax under section 6654(a), and not a penalty) of $42.

Table 3--continued

Date of check/ transaction	Drawer of check	Amount of check
Jan. 4/4, 1980	The Bank of Miami	34,997
Feb. 28/29, 1980	The Bank of Miami	99,997
Mar. 6/10, 1980	The Bank of Miami	74,997
	1980 Total	$209,991

In each instance, Reinaldo was notified by someone at a branch of the Bank of Miami that a check made out to him was at the bank; Reinaldo drove alone to the bank and parked in a nearby parking lot; he walked from there to the bank; he identified himself; he endorsed the check; he received the money in small-denomination bills;[6] he put the money in a briefcase; he went back to his car; and he placed the briefcase in the trunk of his car.

Other Income

In 1980, Maria was employed by Roche Clinical Labs, Inc.; she was paid $11,018 for her services. From this amount, $1,231.70 was withheld as Federal income tax and $665.12 was withheld as F.I.C.A. (Social Security) tax. Petitioners' 1980 tax return does not include these amounts.

In 1980, petitioners received $201 in interest income from Dade Federal Savings and Loan Association, and $143 in interest income from First National Bank. Petitioners' 1980 tax return includes only $144 in interest income.

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[6] Each of the Bank of Miami's currency transaction reports stated that none of the money was in denominations of $100 or greater. Reinaldo testified that he thought he received the money in denominations from $5 through $100.

* * * * * * *

For each of the years 1979 and 1980, petitioners had an underpayment of income taxes required to be shown on their tax return; some part of each such underpayment was due to fraud on the part of Reinaldo; some part of the 1980 underpayment was due to fraud on the part of Maria.

OPINION

Respondent contends that the entire amounts involved in the currency transactions (see table 3, supra) constitute income to petitioners for 1979 ($229,997) and 1980 ($209,991), and that the omission of these amounts from petitioners' tax returns for these years (and the omission from petitioners' 1980 tax return of $11,018 in Maria's wages and $200 in interest) "was engaged in willfully and fraudulently with intent to evade or defeat tax."

Petitioners contend that none of the amounts involved in the currency transactions belonged to petitioners but that Reinaldo was acting on behalf of South Caicos Pride Fisheries, and that there was no deceit by petitioners.

We agree with respondent, except that we agree with petitioners as to fraud on the part of Maria for 1979.

I. Fraud

When respondent seeks to impose the addition to tax under section 6653(b),[7] he bears the burden of proving by clear and convincing evidence that petitioner has an underpayment, and that some part of this underpayment is due to fraud. Section 7454(a);[8] Rule 142(b);[9] e.g., Stone v. Commissioner, 56 T.C. 213, 220 (1971); Otsuki v. Commissioner, 53 T.C. 96, 105 (1969).

The issue of fraud poses a factual question which is to be decided on an examination of all the evidence in the record. Plunkett v. Commissioner, 465 F.2d 299, 303 (CA7 1972), affg. a Memorandum Opinion of this Court;[10] Mensik v. Commissioner,

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[7]

SEC. 6653. FAILURE TO PAY TAX.

* * *

(b) Fraud.--If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. * * * In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

[The subsequent amendment of this provision by section 325(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, 616, does not affect the instant case.]

[8]

SEC. 7454. BURDEN OF PROOF IN FRAUD, FOUNDATION MANAGER, AND TRANSFEREE CASES.

(a) Fraud.--In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect to such issue shall be upon the Secretary.

[9] Unless indicated otherwise, all rule references are to the Tax Court Rules of Practice & Procedure.

[10] T.C. Memo. 1970-274.

328 F.2d 147 (CA7 1964), affg. 37 T.C. 703 (1962); *Stone v. Commissioner*, 56 T.C. at 224; *Stratton v. Commissioner*, 54 T.C. 255, 284 (1970).

Fraud is an actual intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. E.g., *Webb v. Commissioner*, 394 F.2d 366, 377 (CA5 1968), affg. a Memorandum Opinion of this Court;[11] *Powell v. Granquist*, 252 F.2d 56, 60 (CA9 1958); *Estate of Pittard v. Commissioner*, 69 T.C. 391, 400 (1977); *McGee v. Commissioner*, 61 T.C. 249, 256-257 (1973), affd. 519 F.2d 1121 (CA5 1975). This intent may be inferred from circumstantial evidence (*Powell v. Granquist*, 252 at 61; *Gajewski v. Commissioner*, 67 T.C. 181, 200 (1976), affd. without published opinion 578 F.2d 1383 (CA8 1978); *Beaver v. Commissioner*, 55 T.C. 85, 92-93 (1970)), including the implausibility of the taxpayer's explanations. *Boyett v. Commissioner*, 204 F.2d 205, 208 (CA5 1953), affg. a Memorandum Opinion of this Court.[12]

Respondent need not prove the precise amount of underpayment resulting from fraud, but only that there is some underpayment and that some part of it is attributable to fraud. E.g., *Lee v. United States*, 466 F.2d 11, 16-17 (CA5 1972); *Plunkett v. Commissioner*, 465 F.2d at 303; *Kreps v. Commissioner*, 351 F.2d 1, 6 (CA2 1965), affg. 42 T.C. 660 (1964).

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[11] T.C. Memo. 1966-81.

[12] Dated March 14, 1951.

In carrying his burden, respondent may not rely on petitioners' failure to meet their burden of proving error in respondent's determinations as to the deficiencies (e.g., *Habersham-Bey v. Commissioner*, 78 T.C. 304, 312 (1982), and cases there cited).

Petitioners concede that Reinaldo received the $439,988 in the Bank of Miami currency transactions. They claim, essentially, that the money was not Reinaldo's. (See discussions of conduit and other theories in, e.g., *Schuster v. Commissioner*, 84 T.C. 764 (1985), on appeal (CA7, July 23, 1985); *Diamond v. Commissioner*, 56 T.C. 530 (1971), affd. 492 F.2d 286 (CA7 1974).) In his testimony, Reinaldo described the situation essentially as follows:

At some time around 1975, Mavis Harvey Shelley (hereinafter sometimes referred to as "Shelley") came to Diaz Marble Company, Inc.'s place of business (see n.3, *supra*), to look for a piece of marble. In the next few years, Shelley returned to Diaz Marble Company, Inc., several times to look for marble items. On one occasion, Reinaldo sold a small marble table to her. A friendship developed between the two of them. In late 1978 or early 1979, Shelley told Reinaldo that she wanted to build a plant on South Caicos Island (an island in the Caribbean nation of Turks and Caicos Islands) for South Caicos Pride Fisheries (hereinafter sometimes referred to as "Fisheries"), a company which Shelley owned. The plant was to enable Fisheries to process lobsters, fish, and conch. She asked Reinaldo to buy materials, building equipment, and machinery in the Miami area and ship it to South Caicos, so that she could use it to build the plant.

Reinaldo visited South Caicos Island for the first time in 1979. He saw the site of Fisheries' plant, but no construction work had yet begun. Shelley and others who were involved in the construction told Reinaldo what building and other materials (e.g., blocks, cement, plywood, nails) were needed. When Reinaldo returned to Miami, he went price-shopping, and then reported his results to Shelley. Shelley told Reinaldo to order specific items, but not to pay for them until she sent him money.

Shelley transferred money to the Bank of Miami for Reinaldo. Reinaldo received the money in small-denomination bills. Reinaldo paid cash for everything that he bought for Fisheries. The sellers delivered the items to shipping companies. Reinaldo paid cash for the services of the shipping companies.

All of the money Reinaldo spent for Fisheries (purchases and shipping) was in cash and all of it was from the small-denomination bills that Reinaldo received at the Bank of Miami (see table 3, supra). Reinaldo never paid for any Fisheries item out of his own funds. Reinaldo never advanced funds to pay for any Fisheries' item in anticipation of later reimbursement. Reinaldo never received money for any Fisheries item other than the money received in the course of the six currency transactions described in the Findings of Fact, supra.

Shelley never compensated Reinaldo for his services, although she had promised to do so. The only money that he received was the $439,988 in the Bank of Miami currency transactions, plus reimbursement of his expenses, such as his expenses on visits to South Caicos in connection with his purchasing and shipping activities. All of the $439,988 was spent by Reinaldo in the foregoing activities on behalf of Fisheries and under Shelley's authorizations.

Shelley largely corroborated Reinaldo's testimony, although there were a number of discrepancies.

We do not believe Reinaldo's story, even where it was corroborated by Shelley.

Firstly, both Reinaldo and Shelley testified that all of Reinaldo's expenditures for Fisheries (purchases and shipping) were made in cash out of the funds received by him in the Bank of Miami currency transactions. Reinaldo testified that he never used his own funds for those purposes. Both Reinaldo and Shelley testified that every item appearing in certain invoices, customs forms, and shipping bills received into evidence was paid for by Reinaldo in this manner. In their testimony, both Reinaldo and Shelley "tracked" several items through customs forms and shipping bills to show when and how the steps occurred in securing, transporting, and paying for the items.

(a) At least seven of the invoices, totalling about $2,800, were paid before the first of the currency transactions.

(b) At least five of the customs forms (Shipper's Export Declaration) for items (apparently not reflected in the invoices), totalling about $21,000, were for items exported before the first of the currency transactions.

(c) At least nine of the shipping bills, totalling about $12,000, were paid before the first of the currency transactions.

Thus, Reinaldo and Shelley would have us believe that Reinaldo paid at least $36,000 in cash before receiving any money from the currency transactions and they would also have us believe that Reinaldo did not pay anything before he received any money from the currency transactions. We must emphasize that this is not merely a conflict between Reinaldo's testimony on the one hand and Shelley's testimony on the other hand. Rather, the conflict appears within the testimony of Reinaldo and also within the testimony of Shelley. The magnitude of the discrepancy--some $36,000 in 21 payments--convinces us that this was not merely a matter of a failure to remember some small item in testimony given 6 years after the event. The $36,000 discrepancy is substantially more than the total adjusted gross income that petitioners acknowledge for either of the years in issue.[13]

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[13] "That's the way it's done," the Queen said with great decision: "nobody can do two things at once, you know. Let's consider your age to begin with--how old are you?"

"I'm seven and a half, exactly."

"You needn't say 'exactly,'" the Queen remarked. "I can believe it without that. Now I'll give you something to believe. I'm just one hundred and one, five months and a day."

(footnote continued)

Secondly, Reinaldo testified that he was not compensated at all for his extensive activities on behalf of Fisheries. Shelley testified that she compensated Reinaldo in the amount of $800 or $1,000 per month (depending on the extent of Reinaldo's activities during the month) from November 1979 to September or October 1980. Then Shelley testified that all of this was merely to reimburse Reinaldo for his expenses. Then Shelley testified that she paid Reinaldo about $100 or $200 as compensation for his services, in addition to reimbursing him for his expenses. We do not believe that Reinaldo would have continued the extensive work involved in pricing, ordering, paying for, and shipping the various items, not to mention the dangers involved in travelling around Miami with large amounts of small-denomination bills, without being compensated for his labors.

Thirdly, Reinaldo testified that he spent the entire $439,988 for Fisheries in about 12 months without keeping any records of what he spent. We observed Reinaldo on the stand. We do not believe that if he had really been engaged in the

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(footnote continued from previous page)

> "I ca'n't believe *that*!" said Alice.
>
> "Ca'n't you?" the Queen said in a pitying tone. "Try again: draw a long breath, and shut your eyes."
>
> Alice laughed. "There's no use trying," she said: "one *ca'n't* believe impossible things."
>
> "I daresay you haven't had much practice," said the Queen. "When I was your age, I always did it for half-an-hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."

Dodgson, C.L., "The Complete Works of Lewis Carroll" (Through the Looking-Glass), p. 200 (Modern Library ed.).

apparently above-board activities he described he would have been so unconcerned about being able to show that he had faithfully discharged his trust and not kept some of the funds.

Fourthly, the project for which the $439,988 allegedly was spent was the construction of Fisheries' plant on South Caicos. Shelley testified that the plant cost only $85,000, including labor. We do not believe that Reinaldo spent $439,988--or any amount approaching that sum--on the purchasing and shipping of items for Fisheries.

We are convinced that Reinaldo either kept all or part of the $439,988, or was compensated for his services in connection with the currency transactions. None of these funds are reported on petitioners' tax returns. We are convinced that petitioners' explanation of what happened is untrue. See *Boyett v. Commissioner*, *supra*. Petitioners do not suggest another explanation. Petitioners concede 1980 tax return omissions totalling $11,218 and do not suggest any explanation for these omissions. Petitioners do not suggest that the $5,200 "miscellaneous" income item reported on their tax returns (see n.4, *supra*) is related to the currency transactions or any other omissions from income. Petitioners concede that their tax return preparers enquired of both of them as to petitioners' sources and amounts of income and that petitioners' tax returns correctly show all the information they provided to their tax return preparers.

On the basis of the record as a whole, (1) we conclude that respondent has shown that petitioners omitted income from both their 1979 and 1980 tax returns; (2) we conclude that, since there do not appear to be any offsetting deductions or credits, these omissions of income result in an underpayment of tax required to be shown on their tax return for each of the years in issue;[14] (3) we conclude, and we have found, that some part of the 1979 underpayment is due to fraud on the part of Reinaldo; and (4) we conclude, and we have found, that some part of the 1980 underpayment is due to fraud on the part of each petitioner. The foregoing has been proven by clear and convincing evidence.

As to 1979, we note that the entire overpayment results from the 1979 currency transactions. Respondent has failed to persuade us by clear and convincing evidence that Maria knew that petitioners' 1979 joint tax return should have included income on account of these transactions.

We hold for respondent as to Reinaldo for 1979 and 1980. We hold for respondent as to Maria for 1980.

We hold for petitioners as to Maria for 1979.

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[14] Petitioners' reported taxable income for 1980 placed them at the marginal tax rate of 24 percent. (Sec. 1(a).) The conceded 1980 omitted income of $11,218 would have produced more additional tax liability than the additional withholding credit of $1,231.70. Thus, although petitioners are entitled to an additional credit for 1980, there is already an unexplained but conceded underpayment for this year even without regard to the $209,991 in the currency transactions for this year.

II. Deficiencies

Petitioners have the burden of proving that respondent erred in his determinations in the notice of deficiency (other than his determinations as to fraud, discussed supra). Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Except insofar as respondent has conceded that the $439,988 is to be treated as personal service income within the meaning of section 1348 ("maxitax"),[15] petitioners have failed to carry their burden of proof. (Respondent's concession as to petitioners' entitlement to credit against tax for income tax withheld from Maria's wages in 1980 does not affect the amount of the deficiency for 1980, although it does, of course, reduce the amount petitioners have to pay.)

We hold for respondent on this issue.

Decision will be entered
under Rule 155.

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[15] The repeal of this provision by section 101(c)(1) of the Economic Recovery Tax Act of 1981 (Pub. L. 97-34, 95 Stat. 172, 183) does not affect the instant case.

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UNITED STATES TAX COURT

MICHAEL GIALANELLA AND NICOLINA GIALANELLA, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

ITALIAN DELIGHT OF COLUMBIA MALL, INC., Petitioner
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 4568-84, 4569-84. Filed January 30, 1986.

Andrew Jay Graham, for the petitioners.

John F. Dean, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KÖRNER, Judge: In these consolidated cases, respondent determined deficiencies and additions to tax under section 6653(b)[1] for years and in amounts as follows:

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[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

ORIGINAL

Michael Gialanella and Nicolina Gialanella, Docket No. 4568-84

Year Ended Dec. 31	Deficiency	Additions to Tax Sec. 6653(b)
1975	$39,932.18	$19,966.09
1976	58,450.92	29,225.46
1977	60,813.80	30,406.90
1978	66,297.96	33,148.98
1979	69,126.16	34,563.08
1980	71,464.52	35,732.26
1981	68,216.48	34,108.24

Italian Delight of Columbia Mall, Inc., Docket No. 4569-84

Year Ended June 30	Deficiency	Additions to Tax Sec. 6653(b)
1975	$7,621.94	$3,810.97
1976	32,496.35	16,248.17
1977	41,902.08	20,951.04
1978	44,284.80	22,142.40
1979	29,478.08	14,739.04
1980	30,807.20	15,403.60
1981	26,574.80	13,287.40
1982	20,538.05	10,269.02

The issues which we must decide are: (1) The amount of unreported income, if any, received by the respective petitioners in the years shown in the above table; (2) whether the individual petitioners are entitled to itemized deductions in addition to the zero bracket amount for the years 1977 through 1981; (3) whether the individual petitioners suffered a capital loss in 1980; (4) whether the individual petitioners suffered a section 1244 stock loss in the year 1980; (5) whether the corporate petitioner incurred deductible travel expense in 1976; (6) whether the corporate petitioner had deductible expense in connection with an apartment in 1977; (7) whether either or both petitioners are liable for additions to tax under section 6653(b).

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

FINDINGS OF FACT

Petitioners Michael Gialanella and Nicolina Gialanella (hereinafter "Michael" and "Nicolina"), husband and wife, were residents of Baltimore County, Maryland, at the time their petition herein was filed. They filed joint income tax returns with respondent for the calendar years 1975 though 1981. Petitioner Italian Delight of Columbia Mall, Inc. (hereinafter "Italian Delight"), a Maryland corporation with its principal place of business at Columbia, Maryland, filed corporate income tax returns with respondent for its fiscal years ending June 30, 1975, 1976, 1977, 1979, 1980, 1981 and 1982. No return was filed for the fiscal year ending June 30, 1978.

Italian Delight was established at about the beginning of 1975 at Columbia Mall, in Columbia Maryland. It was a restaurant specializing in pizza and other Italian foods, and served customers on the premises as well as for "take out." Michael had a 50 percent interest in the corporation, a 25 percent interest was owned by Bruno Fabi, and another 25 percent interest was owned by Victor DiVivo. In late 1977 or early 1978, DiVivo sold his 25 percent interest to Fabi.

Michael was the day-to-day manager of the operations of the restaurant from its opening through the year 1977. From time to time Nicolina also helped out in the operations of the restaurant.

Money deposited in Italian Delight's bank account formed the basis from which corporate income taxes were computed. Although all sales to customers were made in cash, no cash register tapes or other record of cash receipts was kept. For each of its fiscal years ended June 30, 1975 though June 30, 1982, Italian Delight earned income from the restaurant business which was not reported on its income tax returns for those years. Such income was withheld in cash from the proceeds of sales, or "skimmed," and was divided among the owners of Italian Delight in accordance with their ownership interests. During each of the calendar years 1975 through 1981, Michael and Nicolina received income from skimming the sales proceeds of Italian Delight, which was not reported in their individual income tax returns.

In about 1979 or 1980, a Federal Grand Jury investigation of the activities of Italian Delight was undertaken. Both Michael and Fabi were summoned to appear before the grand jury and testified with regard to skimming operations which were taking place at Italian Delight. Both of them lied in their testimony to the grand jury. Thereafter, both Michael and Fabi were indicted under section 7201 and 18 U.S.C. section 2 (1982), for attempting to evade their income tax with respect to income from Italian Delight. Michael pleaded guilty to the indictment with respect to the year 1977; Fabi pleaded guilty to the indictment with respect to the year 1976. The remaining counts of the indictment were dropped.

Respondent thereafter conducted an investigation of the income tax affairs of Italian Delight, Michael and (apparently) Fabi. As the result of that investigation, including interviews with Michael and Fabi, respondent determined that Italian Delight had unreported income for the years in issue as follows, resulting from the skimming operation:

YEAR ENDED JUNE 30	UNREPORTED INCOME
1975	$ 41,600.00
1976	103,600.00
1977	114,700.00
1978	114,700.00
1979	114,700.00
1980	115,000.00
1981	114,700.00
1982	114,700.00

Respondent determined that Italian Delight had a further $5,685 of unreported income from its operations in 1978 (no return having been filed for that year), and respondent further disallowed a claimed deduction of $2,028 for alleged travel expense in the year 1976, as well as a claimed deduction of $1,993 in the year 1977 for expense in connection with an apartment allegedly owned by Italian Delight.

In the case of Michael and Nicolina, respondent then determined that they had received unreported income from the Italian Delight skimming operation for the calendar years as follows:

YEAR ENDED DEC. 31	UNREPORTED INCOME
1975	$ 88,000.00
1976	114,700.00
1977	114,700.00
1978	114,700.00
1979	114,700.00
1980	115,000.00
1981	114,700.00

In addition, respondent disallowed all claimed itemized deductions and claimed losses by Michael and Nicolina for the years and in the amounts as follows:

YEAR ENDED DEC. 31	ITEMIZED DEDUCTIONS	CAPITAL LOSS	SEC. 1244 STOCK LOSS
1977	$4,446		
1978	4,579		
1979	7,067		
1980	7,785	$3,000	$5,000
1981	7,980	3,000	

Respondent further determined that all petitioners were liable for additions to tax for fraud, under section 6653(b).

Michael and Nicolina had the following expenses in the following years:

ITEM	1978	1979	1980	1981
State and Local Income Tax	$2,167	$2,206	$2,165	$2,165
Realty Taxes	958			
General Sales Tax	339	328	257	299
Home Mortgage Interest	3,174	3,718	3,399	3,358
Credit Card Interest	27			
Charitable Contributions	114	348	253	
Bank Interest			668	
Total	$6,779	$6,600	$6,742	$5,822

A part of the underpayment of tax of each petitioner for each year was due to fraud.

OPINION

The principal issue in these cases concerning the unreported income of Italian Delight and the individual petitioners is not a question of whether there was unreported income; rather, it is a question of how much. The fact that the sales receipts of Italian Delight were skimmed in each of the years in issue, and were not reported in the Italian Delight tax returns nor the individual returns of Michael and Nicolina, was clearly established, and indeed, was admitted on the witness stand by Fabi, Michael and Nicolina. It was also clearly established, based on the testimony of these same witnesses, that they shared in the skimming in accordance with their ownership interests in Italian Delight.

Respondent, after a detailed investigation of the affairs of Italian Delight, determined the amount of unreported income in each year from unreported gross receipts, and set forth this computation clearly in his statutory notice of deficiency. Since Italian Delight had filed no return at all for its fiscal year 1978, respondent further made a determination of the total net taxable income for Italian Delight for that year. Respondent's determination, which was clearly not arbitrary or capricious on its face under the circumstances, was presumptively correct, and petitioners had the burden of proof to show error therein. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Except for the vague and self-serving testimony of Nicolina, Michael and Fabi -- that respondent's determinations of additional income for each year were too high -- there is not a scrap of evidence in this record to show any error in respondent's determination -- no books or records of any kind, no corroborative evidence of the witness' vague statements, nothing. If any record of the amount of skimming was kept by petitioners, it was not produced at trial. If respondent's adjustments were not precise because petitioners had no books or records or failed to produce them, petitioners must suffer the consequences. Figueiredo v. Commissioner, 54 T.C. 1508 (1970), affd. without opinion (9th Cir. 1973); Estate of Mason v. Commissioner, 64 T.C. 651 (1975), affd. 566 F.2d 2 (6th Cir. 1977).

The same statement holds true for the claimed Italian Delight deductions in 1976 and 1977. At trial, no reference at all was made to the travel expense item, and only a brief and unsatisfactory reference in Michael's testimony was made to alleged expenses of maintaining an apartment for employees of Italian Delight, who allegedly worked both there and elsewhere. Such evidence is clearly insufficient to carry petitioners' burden of proof on these issues; there was no evidence that Italian Delight owned such an apartment. It follows that respondent's determinations of unreported income in the case of Italian Delight must be sustained.

With respect to Michael and Nicolina, however, a somewhat different situation is presented. As in the case of Italian Delight, petitioners' evidence in the individual cases was totally insufficient, standing by itself, to show any error in respondent's determination of additional income as to them. The testimony of all three witnesses in this matter -- Michael, Nicolina and Fabi -- was vague, evasive and contradictory in many respects.[2] It was apparent from observing the witnesses on the stand that they would say anything which they thought would be to their advantage, and when unpleasant questions were asked, they had frequent lapses of memory. Other than this totally unsatisfactory testimony, there was nothing presented in this case by petitioners which did anything to carry their necessary burden of proof to show error in respondent's determinations of additional income as to them, except as to one matter.

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[2] Italian Delight's accountant and return preparer also testified, but since he was unaware of the skimming which had taken place, he could contribute nothing of value.

The evidence in this case was clear, and indeed espoused by both sides, that the skimming from Italian Delight was shared among the proprietors in accordance with their ownership interests. We have found this as a fact, and we have further found that Michael's ownership interest in Italian Delight throughout the period was 50 percent. Consistent with respondent's determination of unreported income from skimming in the case of Italian Delight, therefore, it was appropriate and consistent for respondent to attribute half of such skimming proceeds to Michael in each year. This, however, respondent did not do. Instead, respondent attributed to Michael the entire amount which respondent determined to have been skimmed from Italian Delight in the latter's fiscal years 1977 through 1982, and attributed to Michael other, and somewhat lesser amounts, for the years 1975 and 1976. Furthermore, respondent apparently made no effort to adjust such amounts as between Italian Delight and Michael because of the difference in fiscal years which were involved.

Although inconsistent statutory notices issued to different taxpayers do not lose their presumptive correctness in the normal case, such as where one such statutory notice is before us and the other is not, see Meyer v. Commissioner, 46 T.C. 65 (1966), affd. in part, vacated and remanded in part 383 F.2d 883 (8th Cir. 1966); Doggett v. Commissioner, 66 T.C. 101 (1976), the situation is different where both inconsistent statutory notices are before us in the same case, such as this consolidated proceeding. Here we have both the ability and the duty to rationalize respondent's determinations, and correct any inconsistencies, to the end that the petitioners are not "whipsawed" or "doubled up," with the same income being improperly attributed to both.

So far as Michael and Nicolina are concerned, therefore, we think that this record has established error on respondent's part in attributing to them more than one-half of the amounts skimmed from Italian Delight. Furthermore, in order to make a proper attribution of Michael's share of the unreported income from skimming, appropriate adjustment must be made between the fiscal years of Italian Delight and the calendar years of Michael. In the following table, therefore, we show the amount of unreported skimming income from Italian Delight in accordance with respondent's determination, which we have upheld, adjusted in two respects: (a) by attributing the portion thereof in each of Italian Delight's fiscal years to Michael's calendar year in which such portion falls; and (b) taking 50 percent of such amount as Michael's share, in accordance with the proof herein. Thus, for example, Michael's calendar year 1976 would contain the last half of Italian Delight's fiscal year ended June 30, 1976, and the first half of Italian Delight's fiscal year 1977. Such amounts, added together and divided by two, produce Michael's share of the unreported income for his calendar year 1976, in the amount of $54,575. Thus, as shown by the table below, we sustain respondent's determination with respect to the unreported income of Michael and Nicolina in the amounts as shown by the fourth column of the table; the balance of respondent's determination as to the unreported income received by Michael is disapproved.

MICHAEL AND NICOLINA GIALANELLA
50% SHARE OF UNREPORTED CORPORATE RECEIPTS
ADJUSTED TO CALENDAR YEAR BASIS

Italian Delight Fiscal year 6-30	Unreported Receipts	Attributable to Calendar Year	Gialanella One-half Share
1975 (1/2 year)	$ 41,600		
		1975	$46,700
1976	103,600 (1/2)		
		1976	54,575
1977	114,700 (1/2)		
		1977	57,350
1978	114,700 (1/2)		
		1978	57,350
1979	114,700 (1/2)		
		1979	57,425
1980	115,700 (1/2)		
		1980	57,425
1981	114,700 (1/2)		
		1981	57,350
1982	114,700 (1/2)		

We turn now to the various claimed deductions which are in issue in the case of the individual petitioners.

For the year 1977, no evidence at all was presented with respect to the claimed additional itemized deductions, and respondent's determination is accordingly upheld.

With respect to the years 1978, 1979, 1980 and 1981, the evidence in this record supports the itemized deductions as shown in our findings of fact, and appear to be conceded by respondent; they are allowed accordingly. The remainder of the claimed deductions in petitioners' returns are disallowed for failure of proof.

The claim of Michael and Nicolina for capital losses in the years 1980 and 1981, and on account of an alleged section 1244 stock loss in 1980 in the amount of $5,000 must likewise be disallowed. Michael and Nicolina both testified in the most vague and general terms that they had invested $5,000 in the stock of some organization known as the Groceria Italia, Inc., which was a small business corporation, and that they later loaned $20,000 to this organization. When the organization went broke, they testified, they lost all their money. There is nothing else in this record to show what the Groceria Italia was, what interest Michael and Nicolina had in it, nor that they loaned any money to it which was not repaid. Respondent's disallowance of these claimed deductions is accordingly sustained on account of petitioners' failure of proof.

The final issue in this case involves the correctness of respondent's determination that additions to tax for fraud, within the meaning of section 6653(b), are due from all petitioners.

Section 6653(b) provides for the imposition of a 50 percent addition to tax if any part of any underpayment of tax is "due to fraud." Under this statute, fraud is established if it is shown by clear and convincing evidence that the taxpayer intended to evade taxes believed to be owing by conduct designed to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004-1005 (3d Cir. 1968); Webb v. Commissioner, 394 F.2d 366, 377-378 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983). The burden of showing fraud by clear and convincing evidence rests with respondent. Section 7454; Rule 142(b). Respondent has met his necessary burden of proof in this case.

The evidence of fraud runs all through this case. Michael and Nicolina admitted that they skimmed unreported sales receipts from Italian Delight in every one of the years in issue, and that such amounts were reported neither in the corporate return nor in their individual returns to any extent. There is no innocent explanation for skimming. See Budrow v. Commissioner, T.C. Memo. 1983-434; Ball v. Commissioner, T.C. Memo. 1982-474; Yellow Cab and Car Rental Co. v. Commissioner, T.C. Memo. 1974-79. Other recognized badges of fraud which are present in this case are failing to report substantial amounts of income over a period of years, see Lollis v. Commissioner, 595 F.2d 1189 (9th Cir. 1979), affg. T.C. Memo. 1976-15; lying before the grand jury and to the investigating agents, see Zack v. Commissioner, T.C. Memo. 1981-700; and failing to maintain adequate records of income, Nadell v. Commissioner, T.C. Memo. 1974-227. Michael's actions, as half owner of Italian Delight and one of the principals in the skimming scheme, are equally attributable to Italian Delight, whose returns were likewise fraudulent. See Federbush v. Commissioner, 34 T.C. 740 (1960), affd. 325 F.2d 1 (2d Cir. 1963).

As the result of all the above,

Decision under Rule 155
will be entered in docket No. 4568-84.
Decision will be entered for
Respondent in docket No. 4569-84

Ju 11.7/2:1986-45

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T. C. Memo. 1986-45

UNITED STATES TAX COURT

NORMAN G. PAGE, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10087-84. Filed February 3, 1986.

Norman G. Page, pro se.

Dennis Perez, for the respondent.

MEMORANDUM OPINION

DRENNEN, Judge: This case was assigned to Special Trial Judge Lehman C. Aarons pursuant to the provisions of section 7456(c) and (d)[1] and General Order No. 8 (81 T.C. XXIII) for trial, findings of fact and opinion. After reviewing the record we agree with and adopt his opinion which is set forth below.

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

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OPINION OF THE SPECIAL TRIAL JUDGE

AARONS, Special Trial Judge: In separate notices of deficiency respondent determined deficiencies and additions to tax in petitioner's Federal income tax for 1981 and 1982 as follows:

		Additions to Tax		
Year	Tax	Sec. 6654(a)	Sec. 6651(a)	Sec. 6653(a)
1981	$10,285	$ 780.36	$2,562.85	$514.25
1982	11,573	1,011.84	2,657.25	578.65

Respondent also determined additions to tax in both years, under section 6653(a)(2), in the amount of 50 percent of the interest due on the full amount of the underpayment for each year at issue.

Petitioner timely filed his petition herein and at such time he resided in Studio City, California. The petition herein is a form petition closely similar in nature to those filed by several hundred persons in the Southern California area. In his petition petitioner alleges that the determination of tax by respondent is based on "Crimen Falsi" action; that no definition of income appears in the Internal Revenue Code; that no provision of the Code requires anyone to file a return and that such filing is "voluntary"; that respondent is in violation of the Privacy Act of 1979; that respondent has not complied with section 6011 (general requirement of a return); that the Secretary has never assessed a tax on petitioner; that petitioner received nothing of known tangible value that qualified as income during 1981 or 1982; and that petitioner enjoys no grant of privilege or franchise. Petitioner also filed a "Request for Jury Trial", which the Court denied.

Petitioner admits that no returns were filed for 1981 and 1982 and that he received $36,446.60 compensation for his labor in 1981 and $41,361.99 compensation for his labor in 1982.

At the trial, petitioner presented no further facts, but concentrated his argument upon a contention that respondent had no authority to determine a deficiency under section 6211. He based this contention upon the fact that he had filed no return and hence was not a "taxpayer" and accordingly the language "the amount shown as the tax by the taxpayer upon his return", appearing in section 6211(a)(1)(A), cannot apply to him. This contention is, of course, wholly specious. The quoted language refers to the amount to be subtracted from the tax "imposed by subtitle A" (Income Taxes). If there was no return, then the amount to be subtracted from this "tax imposed" is zero. Sec. 301.6211-1(a), Proced. and Admin. Regs. Accordingly, the deficiencies were properly determined as the total amounts of petitioner's tax liability for 1981 and 1982, without any subtractions.

We have dealt so often with petitions similar in all material respects to the petition filed herein that we refuse to expend the time and resources of this Court on an exhaustive analysis of why they are incorrect and why they completely lack merit. See, e.g., Rowlee v. Commissioner, 80 T.C. 1111 (1983); Hughes v. Commissioner, T.C. Memo. 1985-138; Henderson v. Commissioner, T.C. Memo. 1984-520; Fox v. Commissioner, T.C. Memo. 1984-519; Blaty v. Commissioner, T.C. Memo. 1984-518; Dragoun v. Commissioner, T.C. Memo. 1984-94, and cases cited therein. We affirm all respondent's determinations of deficiencies and additions to tax in the notice of deficiency.

Petitioner's allegations in his petition, his arguments to the Court, and his request for jury trial are utterly frivolous, groundless and dilatory. Petitioner was cautioned by the Court of the likely consequences of persisting in following this pattern.

Petitioner was articulate in the argument he presented to the Court. But he is yet another tax protester who has no legitimate dispute with respondent's determinations but instead attempts to use this Court as a forum to avoid the payment of the Federal income tax, or as a playground on which to play ill-conceived games of sophism with the Court. Petitioner has abused the processes of this Court and has wasted its resources and those of respondent. On the basis of the record, we conclude that the proceedings herein were instituted primarily for delay and that petitioner's position is dilatory and is both frivolous and groundless. We are authorized under section 6673 to penalize petitioner for raising dilatory or groundless claims. Sauers v. Commissioner, 771 F.2d 64 (3d Cir. 1985), affg. a Memorandum Opinion of this Court. We accordingly award damages to the United States under section 6673 in the amount of $5,000.

To reflect the foregoing,

An appropriate order
and decision will be entered.

Ju 11.7/2: 1986-46

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T. C. Memo. 1986-46

UNITED STATES TAX COURT

CLARENCE L. MARTIN AND MARGARET L. MARTIN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 23316-83, 31751-83. Filed February 3, 1986.

Donald E. Wharton, for the petitioners.

Debra Bowe and Steven Mopsick, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, Judge: Respondent determined deficiencies in petitioners' income tax for the years 1980 and 1981 in the respective amounts of $5,293 and $5,013, additions to tax under section 6653(a)(1) in the respective amounts of $265 and $250.65

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and an addition to tax under section 6653(a)(2) for the year 1981 to be based on an underpayment of $5,013. Respondent has also requested that the United States be awarded damages under section 6673. The issues for decision are: 1) whether petitioners are entitled to deductions for purported charitable contributions to the Universal Life Church, Inc. Charter No. 33648, Seekers of Truth and Love for the years at issue; 2) whether petitioners are liable for the additions to tax for the years at issue; and 3) whether damages should be awarded under section 6673.

FINDINGS OF FACT

The stipulation of facts and attached exhibits are incorporated herein by this reference. Petitioners resided in California at the time they filed their petition.

During the years at issue, petitioner Clarence L. Martin ("petitioner") was a professor of psychology at American River College in Sacramento, California. His wife, who was employed as a nurse, has not been involved in any way in the alleged church activities which have led to the dispute herein.

Petitioner received Charter No. 33648 from the Universal Life Church, Inc. of Modesto, California on January 2, 1980. He started a congregation at his residence, 8425 Acorn Drive, Roseville, California. The congregation was called Seekers of Truth and Love ("SOTAL"). Through SOTAL, petitioner developed his ideas about religion in general and relationships between people, truth, love and many other related ideas. He published a book titled In Search Of -- A Path to Love, Truth, and Inner Peace and prepared a number of video tapes of various lectures and discussions involving his ideas and teachings.

During this same period, he continued as a professor of psychology at American River College. Many of his SOTAL projects overlapped and were interrelated with what he was doing at the college. One of petitioner's theories was that religion and God were everywhere and that wherever he was, his church was there also. Much of his ministry was conducted at the college. Few meetings were held at his residence.

Petitioner had a master's degree in counselling and guidance and attended two advance counselling institutes. He also was licensed by the State of California as a marriage, family and child counsellor.

On their 1980 income tax return, petitioners claimed a $16,917 deduction for contributions to the Universal Life Church. The deduction consisted of $15,417 in cash and $1,500 for a Lincoln Continental automobile. On their 1981 income tax return, petitioners claimed a $15,600 deduction for a cash contribution to the Universal Life Church. Respondent has disallowed both deductions.

In January 1980 a bank account for SOTAL was opened in the Citizen's Bank of Roseville. Petitioner and David and Nancy Andreotti, petitioner's good friends and next door neighbors, had signatory authority on the SOTAL account. The board of directors of SOTAL was composed of these same three individuals. Petitioner was president, David was treasurer, and Nancy was secretary of SOTAL.

Petitioner was the moving force behind the creation and activities of SOTAL. He signed almost all of the checks which withdrew funds from the SOTAL account and, except for nominal cash donations by third parties, was the sole support of SOTAL. The Andreottis signed checks which paid petitioner his housing allowance. Check signing was the principal activity of the Andreottis with respect to SOTAL.

The funds of SOTAL were used to pay a housing allowance to petitioner in the years 1980 and 1981 in the respective amounts of $8,400 and $9,400 and the expenses of petitioner's book In Search Of -- A Path to Love, Truth, and Inner Peace. Petitioner retained ownership rights to the book. He retained use of the Lincoln Continental which he had transferred to SOTAL. At various times, petitioner used the Lincoln and a 1979 650 Honda motorcycle, which SOTAL purchased, to commute to his job at American River College. All of petitioner's travel expenses were paid by SOTAL. Substantially all of the donations made by petitioner to SOTAL were used to pay him a housing allowance, transportation expenses, and cover other expenses of a personal nature.

In addition to his counselling and lecturing, and general ministering to people on a day-to-day basis, petitioner performed three marriages and officiated at one funeral during the years at issue.

No contributions were made by petitioner to the Universal Life Church, Inc. of Modesto, California and he has made no claim for allowance of charitable deductions based upon the tax exempt status of that organization.

SOTAL does not qualify as a charitable organization, contributions to which are deductible under section 170(c) during the years 1980 and 1981.

OPINION

Although petitioner has received Charter No. 33648 from the Universal Life Church, Inc. of Modesto, California, and operates as the Seekers of Truth and Love Chapter of that organization, he disclaims any affiliation with the Modesto organization and seeks no benefit from its tax exempt status. Petitioner testified that he was seeking to form a church, was looking for a form and structure with which to work, heard of the Universal Life Church, Inc. of Modesto, and used their forms and organizational structure merely as the easiest way to get started with his own church. He did not have legal counsel at that time, and proceeded on his own. Since then, SOTAL has operated on its own, and petitioner now seeks to be judged solely on the activities of SOTAL. Petitioner has discovered that being a chapter of the Universal Life Church does not improve his relationship with the Internal Revenue Service and he is now attempting to put as much distance between himself and the Universal Life Church as he can.

Sections 170(a) and (c) allow as a deduction any charitable contribution that is made during the taxable year if the organization to which the contributions are made is organized and operated exclusively for religious purposes and no part of the net earnings inures to the benefit of any private individual. Deductions are a matter of legislative grace and taxpayers must satisfy the specific requirements of the deductions they claim. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). Taxpayers bear the burden of proving their entitlement to the deductions they claim. Welch v. Helvering, 290 U.S. 111 (1933). These rules apply with equal force to deductions claimed for charitable contributions. Davis v. Commissioner, 81 T.C. 806, 815 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985).

Petitioner contends that SOTAL itself constitutes an entity recognizable under section 170(c) as an entity qualified to receive charitable contributions. In order to be so qualified, petitioner must establish that it was operated exclusively for religious purposes and that no part of the net earnings inured to the benefit of petitioner.

With respect to the first requirement, i.e., exclusively for religious purposes, petitioner points to his teachings of truth and love and his day-to-day ministry to the people with whom he comes in contact. Although the Court would not in any way quarrel with his beliefs and teachings, these activities carried on by petitioner do not constitute a church or an organization organized exclusively for religious purpose within the intent and meaning of section 170(c). SOTAL is more like an alter ego of petitioner than a church organization. See Miedaner v. Commissioner, 81 T.C. 272, 279-280 (1983).

We next get to the question of whether the earnings of SOTAL inured to the benefit of petitioner. It is clear from the record that he was substantially the only contributor to SOTAL. It is also clear from the record that the funds of SOTAL were used to pay expenses of petitioner which, with the possible exception of the book, would have been expended on his own behalf in any event. The only difference before and after SOTAL's formation is that afterwards much of petitioner's personal living and commuting expenses were paid for on an attempted tax deductible basis. Accordingly, we find that the earnings, i.e., the contributions to SOTAL, inured to the benefit of petitioner.

Based on the foregoing, we concluded that SOTAL was not an entity qualified under section 170(c) to receive charitable contributions.

We next get to the question of sections 6653(a) additions and section 6673 damages which we will discuss together. Although petitioner has lost the basic issue here, we cannot conclude on the basis of this particular record that the deductions herein constituted negligence or intentional disregard of rules and regulations. As to damages, exercising our discretion and again on the basis of this particular record, we decline to impose same.

Decisions will be entered

under Rule 155.

Ju 11.7/2: 1986-47

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T. C. Memo. 1986-47

UNITED STATES TAX COURT

TERENCE JOHN GREW, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 28577-82, 33161-83, 24050-84. Filed February 3, 1986.

Peter R. Stromer, for the petitioner.

Donna J. Rice, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, Judge: Respondent determined deficiencies in petitioner's income tax for the years 1977, 1978, 1979, and 1980 in the respective amounts of $1,208, $11,125, $8,664, and $10,192

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and additions to tax under section 6653(a)[1] in the respective amounts of $60, $556, $433, and $510. Respondent has requested damages under section 6673.

The issues for decision are: 1) whether petitioner is entitled to deductions for purported charitable contributions for the years in issue; 2) whether petitioner is entitled to deductions for a long-term capital loss for the year 1978, automobile expenses for 1979, and employee business expenses and investment tax credits for the taxable years 1978 and 1979; 3) whether petitioner is liable for additions to tax under section 6653(a) for the years at issue; and 4) whether damages under 6673 should be awarded.

FINDINGS OF FACT

The stipulation of facts and the attached exhibits are incorporated herein by this reference. Petitioner was a legal resident of San Francisco, California at the time he filed his petition.

Petitioner received a charter from the Universal Life Church, Inc. of Modesto, California, an entity that enjoyed tax exempt status under section 501(c)(3) during the years in issue. Petitioner's congregation of the Universal Life Church had Charter No. 24466 and was known as the Chapel of the Sea. The facility in which the Chapel of the Sea carried on its activities was a 30-foot sailing sloop known as a Catalina 30.

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[1] All section references are to the Internal Revenue Code of 1954 as amended, and in effect during the years in issue.

Petitioner used the sailboat for his own pleasure and for chapter functions. As minister of the Chapter of the Sea congregation, he had discussions aboard the sailboat two and sometimes three times a month relating to the beliefs and tenets of the Universal Life Church. He also occasionally counselled friends and performed approximately 10 marriages. No evidence was presented with respect to the percentage of time that the boat was used for church activities as opposed to other activities. Title to the sailboat was held by petitioner personally and not by the Chapel of the Sea Charter No. 24466.

Petitioner maintained bank accounts in the names of Chapel of the Sea Charter No. 24466 and Universal Life Church, Inc. Charter No. 24466 at the Bank of America. Petitioner had sole signatory authority over these accounts. He also maintained a personal account at the Bank of America. Funds from the Charter No. 24466 accounts as well as funds from his personal account were used to pay the expenses of the sailboat. These payments made up the charitable contributions claimed by petitioner on his returns for the years at issue. Petitioner was not able to substantiate the entire amount of the claimed deductions. He made no contributions to Universal Life Church, Inc. of Modesto, California. He, however, did send quarterly reports to Modesto on behalf of Charter No. 24466. Although these reports provided the basis for receipts sent to petitioner by the Modesto organization at his request, the Universal Life Church in Modesto did not verify petitioner's alleged contributions.

Petitioner is not entitled to any charitable contribution deductions for alleged contributions to Universal Life Church Chapel of the Sea, Charter 24466 or for alleged contributions to any other charitable organization during the taxable years 1977, 1978, 1979, and 1980. Petitioner has offered no proof and has failed to substantiate the deductions for long-term capital loss in the year 1978, automobile expenses for 1979, and employee business expenses and investment tax credits for the taxable years 1978 and 1979.

OPINION

The first issue for decision is whether petitioner is entitled to any deductions for charitable contributions under section 170. Sections 170(a) and (c) allow as a deduction any charitable contribution that is made during the taxable year if the organization to which the contribution is made is organized and operated exclusively for religious purposes and no part of the net earnings inures to the benefit of any private individual. Deductions are a matter of legislative grace and taxpayers must satisfy the specific requirements of the deductions they claim. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). Taxpayers bear the burden of proving their entitlement to the deductions they claim. Welch v. Helvering, 290 U.S. 111 (1933). These rules apply with equal force to deductions claimed for charitable contributions. Davis v. Commissioner, 81 T.C. 806, 815 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985).

The Universal Life Church, Inc. of Modesto, California was determined to be tax exempt under section 501(c)(3) in Universal Life Church, Inc. v. United States, 372 F. Supp. 770 (E.D. Cal. 1974). The Internal Revenue Service has recently withdrawn its recognition of the tax exempt status of the Modesto organization and that decision is presently before the Claims Court.

Petitioner contends that his contributions were made to the Universal Life Church, Inc. of Modesto, California, an organization possessing a charitable exemption during the years at issue. He argues strenuously that the Chapel of the Sea Charter No. 24466 is not a separate organization but is merely a congregation of and really the same organization as the Modesto organization. He contends that setting up a bank account in the name of Chapter 24466 over which he had sole signatory authority was authorized by the Modesto organization and that he was merely acting in a fiduciary capacity for the Modesto organization. It has been found many times, and we find once again, that this argument does not hold water. The Chapel of the Sea is a separate and a distinct organization from the Modesto organization and is not entitled to its tax exempt status. Davis v. Commissioner, supra.[2]

Petitioner has offered receipts from the Modesto organization to support his charitable deductions. As we have found many times before, and once again find, these receipts were prepared for petitioner and supplied to him at his request based upon reports filed by him with the Modesto organization. The Modesto organization made no independent investigation of the underlying facts. The receipts from the Modesto organization are hearsay, do not come under any business records exception as argued by petitioner, and are totally lacking in probative value. Neither the testimony of Bishop Imbeau, Vice President of the Unversal Life Church, Inc. of Modesto, nor the testimony of petitioner, which was largely uncorroborated by either checks or other credible documents, is sufficient to establish that contributions were made.

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[2] Bradfield v. Commissioner, T.C. Memo. 1984-481.

Petitioner maintained complete control over the purported contributions and used them for the expenses of his Catalina 30 sailboat. We find that petitioner's principal objective was to own, operate, and enjoy a 30-foot sailboat on a tax deductible basis, and that his interest in church and religious matters was minimal at best.

Petitioner has rested his entire case on being a congregation and an integral part of the Modesto organization. He has not argued, nor could he, that the activities of the Chapel of the Sea Charter No. 24466 meet the requirements of section 170(c). We note in passing that petitioner has presented some evidence of religious discussions, counselling, and the performance of marriage ceremonies. The record, however, is completely devoid of any evidence with respect to the amount of these activities in relation to the amount of time during which petitioner used his sailboat for pleasure. Proof of religious activities is so vague and minimal that it not only does not support a contribution to Charter 24466, but it casts a cloud of doubt over petitioner's entire case and his general motives.

Several other non Universal Life Church issues were raised in the pleadings, including deductions for a capital loss in connection with an investment at Lake Tahoe, auto expenses, employee business expenses, and investment tax credits. Petitioner has conceded some of these issues and to the extent that he has not conceded the issue, he has introduced no evidence whatsoever to support his position. Accordingly, we sustain respondent's determinations with respect to these issues.

Respondent has determined additions to tax under section 6653(a) for all of the years at issue. Petitioner has failed to prove that respondent's determination in this respect was wrong and the entire record supports the conclusion that petitioner was negligent and in total disregard of rules and regulations in connection with his income tax returns for all of the years at issue.

Finally, we come to the question of section 6673 and respondent's request that the Court award damages pursuant thereto. Petitioner has argued that this section is unconstitutional. Because this argument has been continuously rejected, making it again is in and of itself frivolous and groundless. See Bell v. Commissioner, 85 T.C. 436 (1985), and the cases cited therein. The issues raised by petitioner with respect to his contributions to Universal Life Church Chapel of the Sea

Charter 24466 are also frivolous and groundless. Petitioner was well aware of the strong tide of cases running against him from this Court. Even if he had not known about those cases, no reasonable person could expect that the maintenance and operation of a 30-foot sailboat could result in a charitable contribution deduction. Petitioner has continued to advance legal arguments that have long been settled against him and as such his position is frivolous and groundless. We award damages to the United States in the total amount of $5,000 ($1,000 in Docket No. 28577-82, $2,000 in Docket No. 33161-83, and $2,000 in Docket No. 24050-84).

To reflect the foregoing,

Decisions will be entered
under Rule 155.

Ju 11.7/2:1986-48

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T. C. Memo. 1986-48

UNITED STATES TAX COURT

LAWRENCE A. ROBEN AND MONICA A. ROBEN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 21260-83, 33174-83. Filed February 3, 1986.

Peter R. Stromer, for the petitioners.

M. Kendall Williams, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, *Judge*: Respondent determined deficiencies and additions to tax in petitioners' Federal income tax as follows:

ORIGINAL

		Additions to Tax		
Year	Deficiency	Sec. 6651(a)[1]	§ 6653(a)(1)	§ 6653(a)(2)
1979	$ 7,919	-----	$ 396	-----
1980	8,419	$ 119	423	-----
1981	10,690	423	535	-----[2]

Respondent concedes that no additions to tax are due for 1980 or 1981 under section 6651(a)(1). Respondent, however, now contends that additions to tax are due as follows:

Year	Sec. 6651(a)	Sec. 6653(a)(1)	Sec. 6653(a)(2)
1979	-----	$ 396	-----
1980	conceded	421	-----
1981	conceded	535	-----[2]

The issues for decision are: 1) whether petitioners are entitled to charitable contribution deductions to the Universal Life Church Chapter No. 33069 for the years at issue; 2) whether petitioners are liable for additions to tax under section 6653(a)(1) and section 6653(a)(2); and 3) whether damages should be awarded under section 6673.

FINDINGS OF FACT

The stipulation of facts and attached exhibits are incorporated herein by this reference. Petitioners resided in Saratoga, California at the time they filed their petitions.

Petitioners received Charter No. 33069 from the Universal Life Church, Inc. of Modesto, California, an entity that enjoyed tax exempt status under section 501(c)(3) during the years in issue. Petitioners and Henry W. Miller, who was the treasurer of

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[1] All section references are to the Internal Revenue Code of 1954 as amended, and in effect during the years in issue.

[2] To be computed on an underpayment of $10,690.00.

Chapter No. 33069, were the only members of that congregation. Petitioner Lawrence A. Roben was the minister. There was no evidence about the identity of Henry W. Miller or his relationship to petitioners other than that he was treasurer of the chapter. The only religious and charitable activities claimed by petitioners on behalf of themselves and Chapter No. 33069 were an unspecified number of donations to other charitable organizations in unspecified amounts and counselling "two very close friends who were going through some difficult personal times."

Petitioners established an account in the name of Universal Life Church, Chapter 33069 at the Fairchild Electronics Federal Credit Union (credit union), now known as Technology Federal Credit Union. The signatories on this account were petitioners and Henry W. Miller. Petitioners supplied the credit union with the employer identification number of the Universal Life Church, Inc. of Modesto, California, which number was used on that account. Petitioners maintained an account in their own names at this same credit union. Petitioners transferred monies from time to time from their personal account in the credit union or from a personal account in Wells Fargo Bank to the Universal Life Church Chapter 33069 account at the credit union. Petitioners then almost immediately transferred these monies back to their personal accounts as "parsonage allowances," with the exception of two checks payable to Dean Witter Reynolds, a stock brokerage firm, for an account in that brokerage firm in the name of Universal Life Church Chapter 33069. The record contains no other information about the Dean Witter account. No amounts from the credit union account in the name of Chapter 33069 or from petitioners ever made their way to the Universal Life Church, Inc., Modesto, California.

During the years at issue, petitioner Lawrence Roben worked full time as an engineer for Fairchild Camera and Instrument Corp., and petitioner Monica Roben worked full time as a teacher for the Santa Clara County Schools.

On their tax returns for 1979, 1980 and 1981, petitioners claimed charitable contributions to the Universal Life Church. In his notice of deficiency, respondent disallowed the charitable contributions and determined that additions to tax were applicable. In a motion filed at the hearing, respondent requests damages under section 6673.

OPINION

Section 170(a) and (c) allows as a deduction any charitable contribution that is made during the taxable year if the organization to which the contribution is made is organized and operated exclusively for religious purposes and no part of the net earnings inures to the benefit of any private individual. Deductions are a matter of legislative grace and taxpayers must satisfy the specific requirements of the deductions they claim. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). Taxpayers bear the burden of proving their entitlement to the deductions they claim. Welch v. Helvering, 290 U.S. 111 (1933). These rules apply with equal force to deductions claimed for charitable contributions. Davis v. Commissioner, 81 T.C. 806, 815 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985).

Petitioners contend that the contributions were made to the Universal Life Church, Inc. of Modesto, California. The Modesto organization was determined to be tax exempt under section 501(c)(3) in Universal Life Church, Inc. v. United States, 372 F. Supp. 770 (E.D. Cal. 1974). The Internal Revenue Service has recently withdrawn its recognition of the tax exempt status of the Modesto organization and that question is now before the Claims Court.

All contributions were deposited to the account of Chapter 33069 at the credit union over which petitioners maintained complete control. The use of the Universal Life Church, Inc. of Modesto's employer identification number on that account was meaningless in terms of proving that the monies went to Modesto. In fact, substantially all of the monies were returned to petitioners.

In the alternative, petitioners argue that Charter 33069 itself was entitled to receive tax-deductible charitable contributions. Petitioners presented little evidence regarding the operation of Chapter 33069. There was a vague reference to donations to other charitable organizations, but no evidence as to the number or amount of those contributions. Petitioner Lawrence Roben indicated that he counselled two very close personal friends, but that seemed to be the extent of his church activities. This evidence falls far short of establishing that Chapter 33069 was a church conducting religious activities. In fact, it is so far short that the Court can only conclude that the entire operation was a total sham designed only to avoid income taxes and that no one with the obvious intelligence of petitioners could reasonably have believed that their alleged contributions were legitimate charitable deductions or that the scheme could possibly have worked for tax purposes. It is clear that petitioners' motives were the exact opposite of charitable. It is noted that they both worked for employers which relied heavily on taxes. Petitioners tried hard to see that it was other people's taxes and not theirs which paid the freight.

Petitioners called two witnesses who were involved with other chapters of the Universal Life Church. They knew little or nothing about Chapter 33069 with the result that their testimony was irrelevant. We therefore conclude that the charitable contributions to Universal Life Church claimed by petitioners are not deductible under section 170(c)(2) and that respondent's disallowance of these deductions is sustained.

We also sustain the additions under sections 6653(a)(1) and (2). Petitioners offered no testimony or other evidence to show that their underpayment of tax was not due to negligence or intentional disregard of the revenue laws. Contrariwise, the record as a whole supports the conclusion that petitioners were motivated by greed and avarice and that they totally ignored what any reasonable person would have expected the rules to be with respect to charitable deductions.

Respondent requested the Court to award damages under section 6673 for the reason that petitioners instituted and maintained these proceedings primarily for delay and that their position is frivolous and groundless. Petitioners' position with respect to their alleged charitable contributions has been maintained primarily for delay and is utterly frivolous. Accordingly, we award damages to the United States in the total amount of $5,000 ($2,500 in Docket No. 21260-83 and $2,500 in Docket No. 33174-83).

Decisions will be entered
under Rule 155.

Ju 11.7/2: 1986-49

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MF110

T. C. Memo. 1986-49

UNITED STATES TAX COURT

KENNETH A. HARVEY, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19209-82. Filed February 4, 1986.

Held: Petitioner is not entitled to a theft loss deduction for the fees paid for membership in Life Science Church in the year of payment; held further, additions to tax under sections 6651(a), 6653(a), and 6654(a) are sustained but damages under section 6673 are not imposed.

Ronald J. McDougald, for the petitioner.

Charles W. Maurer, for the respondent.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: For the calendar year 1980, respondent determined deficiencies in income tax and additions to tax as follows:

	Additions to Tax		
Deficiency	Sec. 6651(a)[1]	Sec. 6653(a)	Sec. 6654(a)
$5,454.85	$927.09	$272.74	$240.00

The issues before the Court are whether petitioner is entitled to claim a deduction for a theft loss on account of money paid as a membership fee to the Life Science Church in the year of payment and whether petitioner is liable for the described additions to tax under sections 6651(a), 6653(a), and 6654(a) and for damages under section 6673. For convenience we combine our Findings of Fact and Opinion.

Some of the facts have been stipulated and are so found. At the time of the filing of the petition herein, petitioner Kenneth A. Harvey (Harvey) resided in Winchester, New Hampshire.

Harvey is a 10th grade graduate and in 1980 worked as a carpenter for various employers. In the spring of 1980, he was told about the Life Science Church and attended several meetings including one in Keene, New Hampshire. After several meetings, Harvey decided in June or July 1980 to set up his own Life Science Church in accordance with the information given him.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

Harvey was fully aware of the tax ramifications of his action. Harvey in 1980 paid $3,300 for the documents and instructions as to how to set up his own Life Science Church. The trustees were himself, his wife, and a relative. Harvey signed a vow of poverty, dated June 3, 1980. A copy of the vow was attached to his 1980 Federal income tax return. He amended his W-4's to claim as many dependents as needed to avoid withholding, which in Harvey's case was 20 allowances. This was done prior to formation of the "church." After forming his church, Harvey attended meetings at various places with others similarly situated discussing among other items newspaper articles with respect to Internal Revenue Service enforcement activities. After the Life Science Church became involved in court proceedings, Harvey testified that he and others undertook charitable activities.

In the spring of 1981 he, along with other individuals similarly situated, attended a meeting to receive instruction in filling out his 1981 income tax return. The application filed by Harvey for an employer identification number for his church states that Harvey's church was formed on January 22, 1980, a fact he knew to be incorrect. In prior years, Harvey had used a tax return preparer who also prepared Mrs. Harvey's 1980 Federal income tax return, but he did not consult with him or with anyone else other than Life Science Church representatives with respect to his 1980 tax return.

Harvey used a Treasury Department Form 1040 for his 1980 income tax return. He properly filled out the lines for his name, address, and social security number. He showed his occupation as "minister." At the bottom of the first and second pages of the form, Harvey added a reference to his vow of poverty. In lines 55 and 62 through 64 he stated the amount of tax withheld and claimed a refund of that amount. Finally, he signed his name on the appropriate line and attached to the return his W-2's, his vow of poverty, and some Life Science Church instructions.[2]

Harvey refused to cooperate with respondent's agent when his income tax return was selected for audit and declined to respond to letters from respondent's counsel requesting that Harvey contact counsel. Respondent's counsel also notified Harvey in December 1982 that respondent might request the Court to impose damages under section 6673.

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[2] The original tax return was filled out by Harvey to the extent described in the text in blue ink. It has words and figures stamped on the return in shades of purple and red ink, respectively. In addition the date apparently selected for audit is inserted by hand in light red ink. Finally, by hand, filing status as single is checked, the number "1" is inserted on line 7 (the line for exemptions), the dollar amount of wages shown in the W-2's is inserted as wages on line 8 and as total income and adjusted gross income on lines 22 and 31. These insertions, together with other lines and circles, are all in reddish-brown ink. The stipulation recites that: "All purple and brown notations" on the exhibit were made by respondent's agents. We construe the stipulation to constitute an agreement by petitioner's counsel that Harvey inserted neither income figures nor noted the exemptions claimed on the form. This interpretation is consistent with petitioner's brief.

Harvey's claim of theft loss is predicated on the theory that he was defrauded in 1980 by William E. Drexler (Drexler), the Life Science Church Bishop and Chief Sponsor of these activities. In 1982, Drexler was convicted on several counts, including conspiracy and assisting in the preparation of false income tax returns. However, during 1980 from the time Harvey paid the $3,300 to the Life Science Church representatives through the filing of his 1980 Federal income tax return in April 1981, Harvey apparently believed that he could escape income tax by this action. He continued to adhere to that belief in refusing to cooperate with respondent's agents during the audit of his income tax return, and in the filing of the petition to this Court in July 1982, using what appears to be a printed form for the petition presumably furnished by Life Science Church representatives. Until sometime in 1984 when Harvey employed counsel, he continued to adhere to this Life Science Church charade. Under section 165(e), a loss from theft is deductible only in the taxable year in which the taxpayer discovers such loss. Without in any way implying that petitioner is entitled to a theft loss in some later year, petitioner cannot claim such loss in the year 1980 since he had not at any time during that year "discovered" that he had been defrauded.

Respondent has asserted the addition to tax under section 6651(a) on the theory that the tax return filed by Harvey does not qualify as a tax return under Reiff v. Commissioner, 77 T.C. 1169, 1177 (1981), and other cases. Respondent claims that the

Form 1040 filed by Harvey shows no filing status or claim for exemptions, does not identify Harvey's wife or otherwise indicate his marital status, and shows neither gross, adjusted gross nor taxable income. Similarly, the tax calculation lines are blank. Respondent is correct. The original Form 1040 which was stipulated into evidence fails to provide respondent with sufficient information to determine a tax liability for Harvey for that year. It is true, as petitioner argues, that a gross tax liability could be computed and perhaps a tax return prepared by respondent from the W-2's attached to the return, but this is immaterial. For a form to be recognized as a tax return it must (i) contain sufficient data to calculate the tax, (ii) purport to be a return, (iii) reflect an honest and reasonable attempt to satisfy the requirements of the tax law, and (iv) be executed under penalties of perjury. Beard v. Commissioner, 82 T.C. 766, 777 (1984). The document filed by Harvey meets only the fourth requirement. It does not constitute a tax return for purposes of section 6651(a)(1). See Plante v. Commissioner, T.C. Memo. 1985-117; Howell v. Commissioner, T.C. Memo. 1981-631.

Petitioner also claims that the addition to tax under section 6651(a)(1)is not applicable because he relied upon the advice of the Life Science personnel in preparing the returns. There is no evidence that any of the Life Science personnel who advised petitioner were competent to do so or were undertaking to give independent competent tax advice. See Stevens Bros. Foundation, Inc. v. Commissioner, 39 T.C. 93, 133 (1962), revd.

on another issue 324 F.2d 633 (8th Cir. 1963); United States v. Boyle, 469 U.S. ___ (January 9, 1985). It is significant that Harvey deliberately failed to consult with the accountant who had prepared his income tax returns for several prior years. We hold for respondent on the section 6651(a) addition for failure to file a tax return.

With respect to the addition to tax under section 6653(a) for negligence, Harvey argues that he prepared his tax return in good faith reliance upon the advice of Life Science Church representatives. However, it is quite apparent on this record that Harvey knew that an income tax return was required, that he had filed income tax returns reporting his income in prior years, and in the case of 1980, as we have noted, he made a conscious decision to refrain from consulting with any of the tax return preparers whom he had used in prior years. There is no showing that he made any inquiry as to the competence of any of the Life Science Church representatives to advise as to tax return preparation or tax liability. Harvey has failed to satisfy his burden of proving that no part of his 1980 underpayment was due to negligence or intentional disregard of rules and regulations. We sustain the addition to tax under section 6653(a).

As to the addition to tax under section 6654(a), this addition is mandatory in these circumstances. Extenuating circumstances, if any existed which is not the case herein, would be irrelevant. Estate of Ruben v. Commissioner, 33 T.C. 1071 (1960).

The issue of damages under section 6673 is not entirely clear. There is no evidence before us that petitioner actually knew on the date he filed his petition in this Court that the contentions made were frivolous or that he filed the petition primarily for delay. On the advice of counsel, he at least abandoned any contention with respect to the Life Science Church prior to trial. Accordingly, we give petitioner the benefit of the doubt and deny respondent's request for damages.

Decision will entered
under Rule 155.

Ju 11.7/2:1986-50

T. C. Memo. 1986-50

UNITED STATES TAX COURT

LAWRENCE PETRICCA, Petitioner v
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2682-83. Filed February 4, 1986.

Held: The employment of Lawrence Petricca as an electrician at the Seabrook Nuclear Power Plant during 1980 was indefinite, hence travel expenses are not deductible. Held further, petitioner's charitable contribution to Church of the Angels is not deductible.

Lawrence Petricca, pro se.

Mary P. Hamilton, for respondent.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined a deficiency in the 1980 Federal income tax liability of Lawrence Petricca (petitioner or Petricca) in the amount of $1,797. After concessions, the issues in dispute are the deductibility of travel expenses in the amount of $6,300 for mileage in connection with the work of Petricca at the Seabrook Nuclear Power Plant in Seabrook, New Hampshire and the deductibility of a claimed charitable contribution of $2,500 to the Church of the Angels. For convenience our Findings of Fact and Opinion are combined.

Some of the facts have been stipulated and are so found. At the time of the filing of the petition in this case, Petricca resided in Leominister, Massachusetts.[1] Petitioner is a cash basis taxpayer who filed his Federal income tax returns on a calendar-year basis. The return for the year 1980 was a joint return filed with his then wife Pamela.

Petricca is a member of Electrical Workers Union Local 421 at Concord, New Hampshire. During the period 1977 through 1981 he was assigned by his local union to work at the Seabrook Nuclear Power Plant. He was initially employed by Manzi Electrical Corporation. At some time prior to January 1979 Manzi joined a joint venture working on the nuclear power project which operated under the name Fischbach-Boulos-Manzi. With one exception noted below, Petricca continued to work for this joint venture from that date until he was terminated in March 1981 for violation of a project rule. However, for reasons which are not clear in this record, during 1980 he worked for approximately 1 week for Morrison-Knudsen Company, Inc. Petitioner testified that this brief interruption in his employment by the joint venture was at the direction of the business manager of his local union. We find that this brief interruption in the identity of the employment entity is immaterial to the issues before us. Petitioner also testified, and we have no reason to doubt his testimony, that on numerous occasions he was told to go home for a few days at a time by reason of union problems at the nuclear facility. There is some indication that formal strikes did not occur, but instead employees simply went home until the particular union agent involved told the employees to return to work. This factor again has no bearing on the nature of Petricca's employment for tax purposes.

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[1] The petition was filed in the names of Lawrence Petricca and Pamela Patricca. By order dated July 28, 1983 the case was dismissed as to Pamala Petricca for lack of jurisdiction and the caption changed.

Personal expenses are ordinarily not deductible. Section 262.[2] Section 162(a)(2), however, allows the taxpayer to deduct certain traveling expenses paid or incurred while away from home in the pursuit of a trade or business if he can establish the traveling expenses were: (1) reasonable and necessary;

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[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

(2) incurred while "away from home"; and (3) incurred in pursuit of a trade or business. Commissioner v. Flowers, 326 U.S. 465, 470 (1946); Foote v. Commissioner, 67 T.C. 1, 3 (1976).

The Court has held that a taxpayer's "home" for the purpose of section 162(a)(2) is the vicinity of his principal place of business whenever his personal residence is not located in the same vicinty. Mitchell v. Commissioner, 74 T.C. 578, 581 (1980); Kroll v. Commissioner, 49 T.C. 557 (1968). There is, however, an exception to this rule when a taxpayer with a well-established tax home accepts temporary employment as opposed to indefinite employment elsewhere. In this context, temporary employment means the sort of employment in which termination within a short period of time could be logically expected and foreseen. Groover v. Commissioner, 714 F.2d 1103 (11th Cir. 1983), affg. a Memorandum Opinion of this Court; Albert v. Commissioner, 13 T.C. 129, 131 (1949). See also McCallister v. Commissioner, 70 T.C. 505, 509 (1978). On the other hand, whenever termination of employment cannot be expected or foreseen within a fixed or reasonably short period of time, the taxpayer's tax home shifts to such place of employment so that he cannot satisfy the "away from home" requirement. Verner v. Commissioner, 39 T.C. 749 (1963).

When Petricca was employed, he was not told how long the construction project at the Seabrook Nuclear Power Plant would last but he did know that it was a "big job." For all practical purposes, Petricca's employment as an electrician on this project continued without substantial interruption for a period in excess of 3 years. A fact, if it be a fact, that the business agent of the local can cause union members to be switched from one job to another in the discretion of the business agent is immaterial. That fact alone cannot make Petricca's employment on this job temporary rather than indefinite. The 1-week's employment for Morrison-Knudsen Company, Inc., if done at the instance of the business agent, may illustrate the authority of the business agent to respond to needs of electrical contractors on a particular project, but it cannot serve to convert indefinite employment into temporary employment for Federal tax purposes. During the year 1980, petitioner's Federal tax home was in the vicinity of the Seabrook Nuclear Power Plant in Seabrook, New Hampshire.

Petitioner appears to argue that he comes within the doctrine of Frederick v. United States, 603 F.2d 1292 (8th Cir. 1979). The facts of that case are distinctly different and its rationale has no bearing on this case. There, as the District Court had found, the employment was seasonal with most of the employees laid off during winter months and with no assurance that they would be reemployed when weather permitted. Moreover, that Court of Appeals also recognized that temporary work stoppages such as were present during Petricca's employment at the Seabrook plant do not make the work temporary. Frederick v.

United States, supra. Petricca's commuting expenses were clearly personal and nondeductible unless some portion thereof might be deductible under a different theory.

Without being able to adequately articulate the theory, petitioner nevertheless appears to contend that use of the automobile was necessary to transport Petricca's tools from his home to the job site. Thus, apparently, petitioner is seeking to come within the rule of Fausner v. Commissioner, 413 U.S. 838 (1973). Petitioner did not, however, favor us with a brief in this case and we might well hold that he has abandoned this theory for the allocation of commuting expense between personal and business. Suffice it to say, however, that there is no evidence in this case that Petricca would have failed to use his car for commuting regardless of the tools or that by reason of having to transport tools the commuting expense was in excess of what otherwise would have been incurred. Thus, Petricca has not come within the Fausner rule. See, e.g., McLaughlin v. Commissioner, T.C. Memo. 1982-636.[3]

The final issue is petitioner's entitlement to a deduction under section 170(a) for an alleged charitable contribution made to the Church of the Angels. The only evidence to support this deduction is Petricca's testimony that he paid $2,500 to a person called Al Miner, now deceased, who allegedly had formed a church called the Church of the Angels. To be deductible, a charitable contribution must be made to an organization which qualifies under section 170(c), no part of the net earnings of which inure to the benefit of any individual. The burden of proving entitlement to this deduction is upon petitioner. Rule 142(a). Petitioner has simply failed to carry his burden of proof.

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[3] Respondent argues that petitioner has not complied with the requirements of section 274 in connection with the travel expense deduction and further that the mileage between petitioner's home and the Seabrook Nuclear Power Plant as used by petitioner is excessive. We need not consider these further arguments.

Decision will be entered

under Rule 155.

Ju 11.7/2:1986-51

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T. C. Memo. 1986-51

UNITED STATES TAX COURT

RICHARD M. KELTON, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19909-82. Filed February 4, 1986.

Held: Petitioner is not entitled to a theft loss deduction for the fees paid for membership in Life Science Church in the year of payment; held further, additions to tax under sections 6651(a), 6653(a), and 6654(a) are sustained but damages under section 6673 are not imposed.

Ronald J. McDougald, for the petitioner.

Charles W. Maurer, for the respondent.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: For the calendar year 1980, respondent determined deficiencies in income tax and additions to tax as follows:

	Additions to Tax		
Deficiency	Sec. 6651(a)[1]	Sec. 6653(a)	Sec. 6654(a)
$10,660.88	$1,505.34	$ 533.04	$ 310.00

The issues before the Court are whether petitioner is entitled to claim a deduction for a theft loss on account of money paid as a membership fee to the Life Science Church in the year of payment and whether petitioner is liable for the described additions to tax under sections 6651(a), 6653(a), and 6654(a) and for damages under section 6673. For convenience we combine our Findings of Fact and Opinion.

Some of the facts have been stipulated and are so found. At the time of the filing of the petition herein, petitioner Richard M. Kelton (Kelton) resided in Winchester, New Hampshire.

Kelton is a high school graduate and in 1980 was a driver for United Parcel Service. In the spring of 1980, he was told about the Life Science Church and invited to a meeting at a Ramada Inn in Keene, New Hampshire by an individual by the name of James L. Plante.[2] After attending several more meetings,

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

[2] See Plante v. Commissioner, T.C. Memo. 1985-117, in which substantially the same issues were involved and all were decided against that taxpayer except for damages under sec. 6673. That taxpayer was also employed by United Parcel Service.

Kelton used a Treasury Department Form 1040 for his 1980 income tax return. He properly filled out the lines for his name, address, and social security number. He showed his occupation as "minister." At the bottom of the second page of the form, Kelton added a reference to his vow of poverty. In lines 55 and 62 through 64 he stated the amount of tax withheld and claimed a refund of that amount. Finally, he signed his name and date on the appropriate line and attached to the return his W-2, his vow of poverty, and some Life Science Church instructions. The balance of the return was blank.[3]

Kelton refused to cooperate with respondent's agent when his income tax return was selected for audit and declined to respond to letters from respondent's counsel requesting that Kelton contact counsel. Respondent's counsel also notified Kelton in December 1982 that respondent might request the Court to impose damages under section 6673.

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[3] The original tax return was filled out by Kelton to the extent described in the text in blue ink. It has words and figures stamped on the return in shades of purple and red ink, respectively. In addition the date apparently selected for audit is inserted by hand in light red ink. Finally, by hand, filing status as single is checked, the number "1" is inserted on line 7 (the line for exemptions), the dollar amount of wages shown in the W-2 is inserted as wages on line 8 and as total income and adjusted gross income on lines 22 and 31. These insertions, together with other lines and circles, are all in reddish-brown ink. The stipulation recites that: "All purple and brown notations" on the exhibit were made by respondent's agents. We construe the stipulation to constitute an agreement by petitioner's counsel that Kelton inserted neither income figures nor noted the exemptions claimed on the form. This interpretation is consistent with petitioner's brief.

Kelton decided to set up his own Life Science Church in accordance with the information given him. Kelton was fully aware of the tax ramifications of his action. Petitioner, through his so-called church, intended to and did in fact make gifts, counsel and assist children, and carry out other activities which were of a charitable or religious nature. In the summer of 1980 he paid $3,300 for the documents and instructions as to how to set up his own Life Science Church under the name "New Life Church." The trustees were himself, his wife, and his son; a successor trustee was a niece of his wife. Kelton signed a vow of poverty, a copy of which he attached to his 1980 Federal income tax return. He amended his W-4 to claim 19 allowances, the maximum which his employer's computer system would allow, which substantially eliminated income tax withholding. In the spring of 1981 he, along with other individuals similarly situated, attended a meeting to receive instruction in filling out his 1981 income tax return. During 1980, Kelton became aware that William E. Drexler (Drexler), the Life Science Church Bishop and chief sponsor of these activities, was in trouble with the law. Kelton also admitted that he backdated the vow of poverty to January 22, 1980. In prior years, Kelton had used several tax return preparers, but he did not consult with any of them or with anyone else other than Life Science Church representatives with respect to his 1980 tax return.

Kelton's claim of theft loss is predicated on the theory that he was defrauded in 1980 by Drexler, who in 1982 was convicted on several counts including conspiracy and assisting in the preparation of false income tax returns. However, during 1980 from the time Kelton paid the $3,300 to the Life Science Church representatives through the filing of his 1980 Federal income tax return in April 1981, Kelton apparently believed that he could escape income tax by this action. He continued to adhere to that belief in refusing to cooperate with respondent's agents during the audit of his income tax return and in the filing of the petition to this Court in August 1982, using what appears to be a printed form for the petition presumably furnished by Life Science Church representatives. Until sometime in 1984 when Kelton employed counsel, he continued to adhere to this Life Science Church charade. Under section 165(e) a loss from theft is deductible only in the taxable year in which the taxpayer discovers such loss. Without in any way implying that petitioner is entitled to a theft loss in some later year, petitioner cannot claim such loss in the year 1980 since he had not at any time during that year "discovered" that he had been defrauded.

Respondent has asserted the addition to tax under section 6651(a) on the theory that the tax return filed by Kelton does not qualify as a tax return under Reiff v. Commissioner, 77 T.C. 1169, 1177 (1981), and other cases. Respondent claims that the Form 1040 filed by Kelton shows no filing status or claim for exemptions, does not identify Kelton's wife or otherwise indicate his marital status, and shows neither gross, adjusted gross nor taxable income. Similarly, the tax calculation lines are blank. Respondent is correct. The original Form 1040 which was stipulated into evidence fails to provide respondent with sufficient information to determine a tax liability for Kelton for that year. It is true, as petitioner argues, that a gross tax liability could be computed and perhaps a tax return prepared by respondent from the W-2 attached to the return, but this is immaterial. For a form to be recognized as a tax return it must (i) contain sufficient data to calculate the tax, (ii) purport to be a return, (iii) reflect an honest and reasonable attempt to satisfy the requirements of the tax law, and (iv) be executed under penalties of perjury. Beard v. Commissioner, 82 T.C. 766, 777 (1984). The document filed by Kelton meets only the fourth requirement. It does not constitute a tax return for purposes of section 6651(a)(1). See Plante v. Commissioner, T.C. Memo. 1985-117; Howell v. Commissioner, T.C. Memo. 1981-631.

Petitioner also claims that the addition to tax under section 6651(a)(1) is not applicable because he relied upon the advice of the Life Science personnel in preparing the returns. There is no evidence that any of the Life Science personnel who advised petitioner were competent to do so or were undertaking to give independent competent tax advice. See Stevens Bros. Foundation, Inc. v. Commissioner, 39 T.C. 93, 133 (1962), revd. on another issue 324 F.2d 633 (8th Cir. 1963);

United States v. Boyle, 469 U.S. ___ (January 9, 1985). It is significant that Kelton deliberately failed to consult with the tax return preparers he had used in past years. We hold for respondent on the section 6651(a) addition for failure to file a tax return.

With respect to the addition to tax under section 6653(a) for negligence, Kelton argues that he prepared his tax return in good faith reliance upon the advice of Life Science Church representatives. However, it is quite apparent on this record that Kelton knew that an income tax return was required, that he had filed income tax returns reporting his income in prior years, and in the case of 1980, as we have noted, he made a conscious decision to refrain from consulting with any of the tax return preparers whom he had used in prior years. There is no showing that he made any inquiry as to the competence of any of the Life Science Church representatives to advise as to tax return preparation or tax liability. Kelton has failed to satisfy his burden of proving that no part of his 1980 underpayment was due to negligence or intentional disregard of rules and regulations. We sustain the addition to tax under section 6653(a).

As to the addition to tax under section 6654(a), this addition is mandatory in these circumstances. Extenuating circumstances, if any existed, which is not the case herein, would be irrelevant. Estate of Ruben v. Commissioner, 33 T.C. 1071 (1960).

The issue of damages under section 6673 is not entirely clear. There is no evidence before us that petitioner actually knew on the date he filed his petition in this Court that the contentions made were frivolous or that he filed the petition primarily for delay. On the advice of counsel, he at least abandoned any contention with respect to the Life Science Church prior to trial. Accordingly, we give petitioner the benefit of the doubt and deny respondent's request for damages.

Decision will entered
under Rule 155.

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T. C. Memo. 1986-52

UNITED STATES TAX COURT

EUGENE MATTHEWS, Petitioner *v*.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 33002-83. Filed February 5, 1986.

William A. Patterson, for the petitioner.

Frank Simmons, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KÖRNER, *Judge*: Respondent determined deficiencies in income tax and additions to tax against petitioner for the years and in the amounts as follows:

CALENDAR YEAR	DEFICIENCY	ADDITIONS TO TAX SECTION 6653(b)[1]
1973	$ 3,728.73	$ 1,864.37
1974	23,685.44	11,842.72

After concessions by both sides, the remaining issues to be decided are:

1. Whether petitioner's returns for the years in issue were fraudulent within the meaning of section 6653(b), which will control, and

2. Whether the assessment of deficiencies against petitioner for either year is barred by the applicable statute of limitations.

Many of the facts herein were established by order of the Court under Rule 91(f), pursuant to proposed stipulations of fact submitted by respondent, to which petitioner did not object, and such stipulations, with accompanying exhibits, are incorporated herein by this reference.

FINDINGS OF FACT

Petitioner was a resident of Tylertown, Mississippi, at the time of filing his petition herein. Petitioner timely filed joint income tax returns with his wife, Mattie Matthews, for the calendar years 1973 and 1974.[2] An amended return for the year 1974 was filed on or about September 2, 1981, claiming a refund of $177.53, based upon the carryback of an unused new jobs credit.[3]

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[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

Petitioner completed high school and a two-year mechanics course at the Vocational Technical Division of Alcorn College in Mississippi. Beginning at the time of his discharge from the military in 1971, and continuing through 1973 and 1974, petitioner operated a logging business as a sole proprietor. His business during 1973 and 1974 consisted primarily of cutting timber which had been purchased by various firms from the landowners. Petitioner also cut and sold some timber which he purchased from the landowners. During this period, he had six or seven employees. He maintained only one checking account for both his business and personal use, but he also maintained three savings accounts with banks.

In the years in issue, petitioner was solely responsible for operation of the business and maintenance of business records. Such business records consisted solely of bank statements, canceled checks, deposit slips, invoices, logging tickets and vouchers for logging tickets. No formal set of books or records was maintained. Petitioner paid some of his business expenses by check and some by cash. He paid his employees in cash. Upon receipt of a check for timber hauled or sold, petitioner cashed the check and kept in his pocket the cash he expected to need for expenses for the following week. He deposited the remainder of the proceeds of the check to the checking account or one of the savings accounts.

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[2] Although joint returns were filed for both years, the record does not disclose that any statutory notice of deficiency was issued to anyone but petitioner, and only he has filed a petition herein.

[3] Respondent has conceded the correctness of this adjustment.

Petitioner and his wife had their joint income tax returns for 1973 and 1974 prepared by a local certified public accountant, who did no audit of petitioner's books or records, but simply prepared the returns from information furnished by petitioner. Such information consisted of a list of income and expenses prepared by petitioner and furnished to the CPA by him. The gross income figures were prepared from stubs of the income checks which petitioner received from persons or firms to whom he sold timber or for whom he hauled timber. The list of expenses was prepared from sales tickets and canceled checks.

During the years 1973 and 1974, petitioner had interest income from one or more of the banks in which he maintained savings accounts, in the total amount of $1,332.73 in 1973 and $2,480.96 in 1974. Such interest income information was not furnished to the CPA and was not reported in petitioner's returns. The banks involved furnished petitioner with periodic statements of his savings accounts and, at the end of the year, furnished a statement of total interest earned on the account during the year, calling attention to the fact that such interest was a Federal income tax item.

Petitioner's returns for 1973 and 1974 were audited by a regular revenue agent as well as a special intelligence agent. In the course of their investigation, the agents sought to determine the firms with whom petitioner had done business and from whom petitioner derived gross income. Petitioner represented to the agents that he had done business with and derived income from only three firms in each of the years in question. Upon canvassing the local area, however, the agents discovered that in fact petitioner had done business with six different firms in 1973 and seven such firms in 1974, who made payments of gross income directly to petitioner. Although petitioner reported gross income from his logging business for 1973 and 1974 in the respective amounts of $120,768.15 and $146,429.73, the actual amounts of gross income from logging in those two years were $147,886.30 and $196,964.23, respectively.

Determining that petitioner's books and records were inadequate as a basis for computing his taxable income, respondent recomputed petitioner's income for the years in question on the net worth plus unallowable expenditures basis. As a result, respondent determined that petitioner had unreported net taxable income for 1973 in the amount of $12,316.91, and

$65,671.30 for 1974, and determined the instant deficiencies accordingly, together with additions to tax under section 6653(b) for fraud.

Part of the underpayment of tax in each of the years 1973 and 1974 was due to fraud.

OPINION

Petitioner has conceded the correctness of respondent's determination of deficiencies for 1973 and 1974, as well as the correctness of respondent's use of the net worth method. It remains only for us to determine whether any part of the resulting underpayment of tax for each year was due to fraud within the meaning of section 6653(b). The burden of proving fraud is on respondent, and he must do so by clear and convincing evidence. Section 7454(a); Rule 142(b); Stone v. Commissioner, 56 T.C. 213, 220 (1971). This burden may be met by showing that the taxpayer intended to conceal, mislead, or otherwise prevent the collection of taxes, and that there is an underpayment of tax. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); Acker v. Commissioner, 26 T.C. 107, 112 (1956).

When fraud is determined, as in the instant case, for more than one taxable year, respondent must show that some part of an underpayment was due to fraud for each taxable year for the corresponding addition to tax to be upheld. Professional Services v. Commissioner, 79 T.C. 888, 930 (1982); Nicholas v. Commissioner, 70 T.C. 1057, 1065 (1978); Otsuki v. Commissioner, 53 T.C. 96, 105 (1969). The existence of fraud is a question of fact to be resolved upon a consideration of the entire record. Rowlee v. Commissioner, supra at 1123; Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1381 (8th Cir. 1978). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Fraud may, however, be proved by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. Stephenson v. Commissioner, 79 T.C. 995, 1005-1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984); Gajewski v. Commissioner, 67 T.C. at 200. The taxpayer's entire course of conduct may establish the requisite fraudulent intent. Spies v. United States, 317 U.S. 492 (1943); Gajewski v. Commissioner, 67 T.C. at 200; Stone v. Commissioner, supra at 223-224.

Although petitioner's failure to keep adequate books and records from which his income could be determined is certainly a suspicious circumstance, this fact standing alone in the instant case would be insufficient to carry respondent's necessary burden of proof to establish fraud. In this case, however, there is more. Petitioner, a reasonably well-educated man, knew all about bank savings accounts and used them extensively to earn interest on his funds. The banks notified him of his annual interest earnings, and he was on notice that these were taxable income items. Nevertheless, it appears that he did not notify his return preparer of his interest earnings in either of the years in question. Although the amounts of unreported income from interest were not large, they were too large to have escaped petitioner's attention, and we find no innocent explanation for their omission.

More important, and what we consider to be conclusive in this case, is the fact that petitioner misrepresented the sources of his logging income when asked about these sources by the revenue agents. He claimed to have done business with only three firms in each of the years in question, but the evidence is clear, based upon canceled checks which are in this record, that petitioner did business with six different firms in 1973 and seven firms in 1974, all of whom made payments directly to petitioner, as shown by canceled checks and invoices. Petitioner attempted to explain this discrepancy by saying that he was paid by the undisclosed firms through one of the firms with whom he did business and which he had disclosed to the agents, but the documentary evidence in this record clearly shows that this is not true. Misrepresenting facts, failing to inform or otherwise misleading a taxpayer's return preparer or a revenue agent can be persuasive evidence of fraud. Cf. *United States v. Newman*, 468 F.2d 791, 794 (5th Cir. 1972); *Estate of Vella v. Commissioner*, T.C. Memo. 1982-73.

We accordingly have found that petitioner's concealment of the sources of his income from the examining agents was deliberate, that the omission of income was substantial, and we hold that respondent has sustained his necessary burden of proof with respect to fraud for each year. Once fraud is proved as to any part of the underpayment, the addition to tax attaches to the entire deficiency. See Shaw v. Commissioner, 27 T.C. 561, 570 (1956), affd. 252 F.2d 681 (6th Cir. 1958).

The resolution of this issue likewise resolves the remaining issue of the statute of limitations in favor of respondent. Respondent's notice of deficiency was issued more than three years after the filing of petitioner's returns, and normally would be barred by the three-year statute of limitations under section 6501(a), and petitioner affirmatively pleaded the bar of the statute of limitations in this case. Rule 39. Under the provisions of section 6501(c)(1), however, respondent may determine the deficiency and assess the tax at any time in the case of a false or a fraudulent return. We accordingly decide this issue in favor of respondent.

Decision will be
entered under Rule 155.

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T. C. Memo. 1986-53

UNITED STATES TAX COURT

LEONARD E. TREISTER AND DIANA TREISTER, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 16043-79. Filed February 6, 1986.

Prior to the years in issue, P served as chief executive officer, president and chairman of the board of HCA, a corporation involved in certain government-sponsored turnkey housing projects. In August, 1973, P resigned from these positions. Contemporaneously with his departure from HCA, A agreed to purchase P's HCA stock for $225,000 and to pay compensation of $75,000 to P for his availability for consulting services. During the years in issue, P received payments totaling $75,000 from A. *Held*, P received the payments in issue as compensation for his availability for consulting services rather than as additional consideration for his HCA stock.

James E. Burk and *Sam Konigsberg*, for the petitioners.

Kevin J. Yourman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

NIMS, Judge: Respondent determined deficiencies of $12,492 and $8,077 in petitioners' 1975 and 1976 Federal income tax returns, respectively. The sole issue for decision is whether petitioner received certain payments during 1975 and 1976 as compensation for services or in exchange for certain stock.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Leonard E. Treister (petitioner) and Diana Treister, husband and wife, resided in North Miami, Florida, when they filed the petition in this case.

Sometime prior to December 26, 1968, petitioner, an attorney, together with his brother Kenneth Treister (Ken), an architect, formed Lenken Corporation (Lenken). Petitioner and Ken each received 50 percent of Lenken's issued and outstanding common stock.

On December 26, 1968, Lenken and Alcoa Properties, Inc. (Alcoa), formed Housing Corporation of America (HCA) to participate in certain government-sponsored turnkey housing projects. Lenken and Alcoa received 49 percent (490 shares) and 51 percent (510 shares) of HCA's issued and outstanding common stock, respectively. On the above date, petitioner and Ken each entered into a management agreement with HCA. Pursuant to these agreements, petitioner became the chief executive officer of HCA and Ken became the president of HCA. Petitioner and Ken were also elected to HCA's board of directors.

As an employee of HCA, petitioner was in charge of the overall management of the company. Ken, on the other hand, was involved with the technical aspects of the company.

On December 31, 1972, Ken and petitioner entered into an agreement with Alcoa and HCA which provided, in pertinent part, as follows:

> SALE AND TRANSFER OF STOCK
>
> Section 3.1. KENNETH agrees to obtain by way of redemption of his stock of LENKEN, and to sell to API, and API agrees to purchase from KENNETH on January 4, 1973, 245 of the Common Shares of HCA (par value ten dollars per share) for a consideration of $225,000, payable in cash upon delivery of certificates for such Shares properly endorsed for transfer to API, free and clear of liens, claims and encumbrances. KENNETH and LEONARD agree to take such steps as are necessary and appropriate to effectuate the transfer of such Shares by LENKEN to KENNETH, for sale to API. Closing of the sale of stock by KENNETH to API shall be held at the office of HCA in Miami, Florida.

On the above date, Ken and HCA also entered into a written "Agreement for Services" which provided that Ken, at HCA's request, would perform certain architectural services with respect to certain projects identified in the service agreement. The service agreement further provided that Ken would receive compensation of $75,000 for his availability for consulting services.

On or about December 31, 1972, the Lenken stock owned by Ken was redeemed for 245 shares of HCA stock.[1] Ken then sold the HCA stock he received in the redemption to Alcoa for $225,000.

On January 4, 1973, Ken resigned as president of HCA and as a member of HCA's board of directors. On that same date, petitioner and HCA entered into a written "Amended Management Agreement" which provided for petitioner's employment by HCA as its president and chief executive officer through December 31, 1974, at an annual salary of $75,000. Also on January 4, 1973, Alcoa and petitioner entered into a written "Agreement" (hereinafter sometimes referred to as the January 4 agreement) granting to petitioner an option, which was exercisable after December 31, 1974, to require Alcoa to purchase for $225,000 the HCA stock owned by Lenken. The agreement further provided that if petitioner exercised this option, Alcoa would cause HCA to enter into an agreement with petitioner "for services (not to exceed 10% of his available working time) for a period of 18 months, as compensation for which HCA shall pay to LEONARD the sum of $75,000, payable in equal installments at the end of the sixth, twelfth and eighteenth months."

Sometime prior to August 8, 1973, petitioner was asked to resign as president and chief executive officer of HCA. On or about August 8, 1973, petitioner traveled to California to discuss his departure from HCA with Robert Hatfield (Hatfield), the president of Alcoa. During the course of this discussion, Hatfield and petitioner decided to modify the "Agreement" and the "Amended Management Agreement" dated January 4, 1973. To evidence the terms of the new agreement, the two men composed a letter dated August 8, 1973 (the August 8 agreement), which was addressed to petitioner from Alcoa, providing in pertinent part as follows:

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[1] This amount represented one-half of the HCA stock owned by Lenken.

* * *

> 2. Leonard will remain in the employ of HCA and/or API as a consultant on corporate matters (but shall be relieved of any obligation to perform executive and/or management tasks or duties) until December 31, 1974, and thereafter for an additional eighteen (18) months in accordance with Paragraph 2 of the Agreement.

* * *

> 4. During the eighteen month period of employment following December 31, 1974, Leonard will perform consulting services not to exceed ten percent (10%) of his available working time, and as compensation for which HCA shall pay to Leonard the sum of Seventy Five Thousand Dollars ($75,000.00), payable in equal installments at the end of the sixth (6th), twelfth (12th) and eighteenth (18th) months. API will guarantee to Leonard the payment by HCA of compensation payable to Leonard under such agreement, not to exceed in the aggregate the sum of $75,000.00.

* * *

> 6. API will purchase for the sum of Two Hundred Twenty Five Thousand Dollars ($225,000.00) all of the stock of HCA (245 common shares) now owned by Lenken Corporation (controlled by Leonard). The purchase price will be paid in cash within thirty (30) days from the date hereof against delivery to API of said shares free and clear of all liens, claims and encumbrances and endorsed or otherwise transferable to API.

* * *

9. This agreement, taken in conjunction with the Agreement and Amended Management Agreement, copies of which are attached hereto as Exhibits A and B, shall constitute the entire understanding among the parties with respect to the subject matter hereto, superseding all negotiations and prior discussions. In the event there is a conflict between the terms of this agreement and the terms of the Agreement or the Amended Management Agreement, the terms of this agreement shall govern. This agreement shall not be altered, modified or amended except by a later writing duly executed by all the parties hereto.

This agreement shall not be effective or valid until it is signed by all of the signatories hereto. The fact that this agreement may be initialled by any of the parties shall not validate it or make it effective.

Very truly yours,

ALCOA PROPERTIES, INC.

By ____________________

AGREED:

HOUSING CORPORATION OF AMERICA

By ______________________________

LENKEN CORPORATION

By ______________________________

____

LEONARD E. TREISTER

Petitioner initialled each page of the agreement and also signed the agreement in his individual capacity and on behalf of Lenken. Although Hatfield initialled each page of the agreement, he did not sign the agreement because he wanted an attorney to review the agreement. No representative for Alcoa or HCA signed the agreement.

While on an airplane returning to Miami from California, petitioner reviewed the August 8 agreement and made the following notations on the letter. Petitioner circled the word "employment" found in the first line of paragraph 4 and inserted the words "in error" and "call Greg Kerr" in the margin next to paragraph 4.[2] Petitioner also circled the word "compensation" found in the fourth and ninth lines of paragraph 4 and inserted the words "omit" and "additional consideration for LET interest" in the margin adjacent to paragraph 4.

Following his return to Miami, petitioner called Mr. Kerr and explained to him that the August 8 agreement should be amended to reflect that the payment of $75,000 was additional consideration for his HCA stock rather than compensation for services. Petitioner, however, could not remember if another agreement was ever executed.

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[2] Greg Kerr was a member of the law firm Eckert, Seamans, Cherin and Mellot in Pittsburgh, Pennsylvania. Mr. Kerr served as outside counsel to Alcoa during the years in issue.

In August or September, 1973, petitioner received a payment of $225,000 from Alcoa for his 245 shares of HCA stock.[3] In November, 1974, petitioner left the premises of HCA and returned to a full-time law practice in Miami, Florida.

Subsequent to 1974, petitioner's sole contact with HCA was to respond to a subpoena for a deposition. Petitioner performed no significant services for HCA nor was he requested to do so after 1974.

During 1975 and 1976, petitioner received payments of $49,974 and $25,000, respectively, from HCA. On Alcoa's consolidated returns for 1975 and 1976, HCA deducted these payments as management fees. On Schedule D attached to their 1975 and 1976 Federal income tax returns, petitioners reported these amounts as long-term capital gain, treating the payments as additional consideration for petitioner's HCA stock. In the notice of deficiency, respondent determined that petitioner had received these payments as compensation for services and, therefore, should have reported these amounts as ordinary income.

On May 13, 1983, petitioner filed a voluntary petition under Chapter 7 of the Bankruptcy Act in the United States Bankruptcy Court for the Southern District of New York. Petitioner was granted a discharge in bankruptcy by order of the bankruptcy court dated October 5, 1983. On March 8, 1985, respondent filed with the bankruptcy court an amended proof of claim which included the 1975 and 1976 Federal income tax claims at issue here. Petitioner subsequently filed a motion with the bankruptcy court requesting that the court declare respondent's 1975 and 1976 claims dischargeable. In In re Treister, ___ Bankr. ___ (Bankr. S.D.N.Y. 1985), the bankruptcy court denied petitioner's motion, holding that respondent's 1975 and 1976 income tax claims had not been discharged in bankruptcy.

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[3] The record does not disclose when petitioner received legal title to the HCA shares from Lenken.

OPINION

The issue for decision is whether the payments petitioner received from HCA during 1975 and 1976 constitute additional consideration for his HCA stock or compensation for his availability for consulting services. Petitioners argue that although the form of the payments was compensation for services, the payments, in substance, were additional consideration for petitioner's HCA stock. Respondent disagrees, contending that the form and substance of the payments in issue were compensation for petitioner's availability for consulting services. Respondent relies on the application of the "mistake, undue influence, fraud, duress, etc." rule of Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), or the "strong proof" rule of Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), affirming 29 T.C. 129 (1957), to support his position. Although we agree that the payments in issue constitute compensation for petitioner's availability for consulting services, we do not think that either Danielson or Ullman is applicable to the facts presented herein.

In Danielson, the Third Circuit adopted the following rule of law:

> [A] party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc. [378 F.2d at 775.]

In Ullman, the Second Circuit stated that a taxpayer must present "strong proof" that the form of a contract does not reflect its substance before the tax consequences apparent on its face will be disregarded.

In both Danielson and Ullman, the taxpayers were attempting to avoid the value assigned in legally enforceable sales contracts to covenants not to compete. In the instant case, however, petitioners are not challenging the terms of a legally enforceable agreement. The January 4 agreement grants to petitioner an option, which was exercisable after December 31, 1974, to require Alcoa to purchase the HCA stock owned by Lenken. This agreement further provides that Alcoa will cause HCA to enter into a service agreement with petitioner if and when he exercises this option. Alcoa, however, purchased petitioner's HCA stock in August or September, 1973, which was prior to the effective date of the option. Consequently, Alcoa did not purchase the HCA stock pursuant to the option and, therefore, Alcoa was not obligated under the January 4 agreement to cause HCA to enter into a service agreement with petitioner.

The August 8 agreement is likewise unenforceable. Pursuant to its terms, the August 8 agreement did not become effective until it was signed by all of the signatories thereto. Because Alcoa and HCA were both required signatories to the agreement, and representatives for neither company signed the agreement, the agreement, by its terms, is not legally enforceable.

Although petitioners do not have to satisfy the Danielson rule or the Ullman rule to prevail in this case, they nevertheless bear the burden of proving by a preponderance of the evidence that the substance of the transaction differed from its form. Rule 142(a).[4] After a careful review of the facts before us, we find that petitioners have failed to satisfy this burden.

The record clearly establishes and petitioners do not dispute that the payments, in form, were compensation for petitioner's availability for consulting services. The August 8 agreement provided that Alcoa would pay cash of $225,000 for the HCA stock owned by Lenken within 30 days of the date of the agreement. The agreement further provided that petitioner would receive compensation of $75,000 for his availability for consulting services, which was payable in equal installments at the end of the sixth, twelfth and eighteenth months following his departure from the company on December 31, 1974. In August or September, 1973, as provided in the August 8 agreement, petitioner received a payment of $225,000 for his HCA stock. Also as provided in this agreement petitioner subsequently received payments of $49,974 and $25,000 from Alcoa in 1975 and 1976, respectively, for his availability for consulting services.

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[4] Unless otherwise indicated, all rule references are to the Tax Court Rules of Practice and Procedure.

Petitioners nevertheless contend that although the form of the payments in issue was compensation for services, the substance of the payments was additional consideration for petitioner's HCA stock. To support their position, petitioners rely on Coven v. Commissioner, 66 T.C. 295 (1976). In Coven the taxpayer, who was one of five partners in an accounting firm, decided to withdraw from the accounting firm for medical reasons. Although the taxpayer initially agreed to sell his partnership interest to another partner in the accounting firm, the taxpayer and purchasing partner subsequently entered into a "consultant agreement" which superseded the original sales agreement. The consultant agreement provided that the taxpayer would receive certain cash payments from the purchasing partner as a consultant to the accounting firm. In Coven we disregarded the form of the consultant agreement and found that the taxpayer had, in substance, sold his partnership interest. In so finding we relied on the following factors:

> (1) Consulting services were to be rendered only at petitioner's convenience, and only if his health and other business commitments permitted; (2) if petitioner and his wife died before 1991, the survivor's estate would receive a lump-sum payment, declining from

> $204,050 in 1966 to $6,761.30 in 1990. There is accordingly a total lack of correlation--in fact, it would be an inverse ratio--between the services rendered and the amount of these lump-sum payments; (3) payments could continue well after petitioner's death, for the duration of his wife's life, if she survived him; (4) only a few phone calls have been made to petitioner, and no formal consultation services actually have been rendered under the contract; and (5) petitioner did not expect to render consulting services when the agreement was executed. [Footnote omitted. 66 T.C. at 304.]

The facts of the instant case are distinguishable from the situation in Coven. First, in Coven the Court found that the taxpayer need only render consulting services at his convenience and only if his health and other business commitments permitted. In the instant case petitioner was expected to render consulting services at the discretion of the management of Alcoa and HCA. Also, as evidenced by the August 8 agreement, petitioner and Alcoa intended that the management of HCA would have access to 10 percent of petitioner's available working time, regardless of his other business commitments. In the absence of evidence to the contrary, we also assume that petitioner's health would not have prevented him from rendering the requested services.

In Coven the consultant agreement provided that payments would continue for a period of 25 years in the event the taxpayer or his wife survived for that period of time. In the event the taxpayer and his wife died prior to the expiration of the 25-year period, the survivor's estate would receive a lump-sum payment pursuant to the terms of the consultant agreement. Here, petitioner's obligation to perform consulting services and his right to payment terminated after 18 months. Further, the record contains no evidence suggesting that petitioner, his wife or his estate was entitled to payment of any kind in the event petitioner was unavailable for consulting services.

Although petitioner did not actually render consulting services to HCA or Alcoa after December 31, 1974, we are satisfied that petitioner and Hatfield reasonably anticipated that petitioner would render consulting services to the management of HCA after his departure from the company. At trial Hatfield explained that:

> [Petitioner] having been the chief executive officer of the company, was aware of the various projects that were underway, and as it was obvious that we faced serious litigation in most of these projects, we wanted [petitioner's] expertise and advice and availability to us, during this period of time, as we tried to resolve our problems.

Petitioner admitted at trial that he and Hatfield had discussed the inexperience of Alcoa's board of directors with respect to real estate matters and thus the necessity of retaining petitioner's availability for consulting services. Although petitioner further testified that his "intention was to be paid and to leave", the record contains no evidence that he discussed his intention with Hatfield. Indeed, Hatfield stated that petitioner never suggested to him that they characterize the final payment of $75,000 as additional consideration for the HCA stock. Moreover, petitioner signed the August 8 agreement, thus evidencing his intent to render consulting services if requested by HCA's management. We note that petitioner testified that he subsequently discussed modifications to the August 8 agreement with Kerr, an attorney for Alcoa. Petitioner, however, did not present Kerr's testimony at trial. Moreover, petitioner stated at trial that he could not remember whether a subsequent agreement evidencing his suggested modificatons was ever drafted.

We also note that the record establishes and petitioner does not dispute that petitioner's brother, Ken, received $225,000 from Alcoa for his 245 shares of HCA stock. Petitioner nevertheless asks us to find that Alcoa agreed to purchase his 245 shares of HCA stock for $300,000. The record, however, contains no evidence which would support a finding that petitioner's interest in HCA was worth $75,000 more than his brother's interest in the company. Thus, in the absence of evidence to the contrary, we conclude that Alcoa intended to treat petitioner and his brother equally and thus agreed to pay petitioner no more than $225,000 for his HCA stock.

Petitioners also argue that Alcoa's failure to withhold the appropriate taxes from the payments in issue establishes that HCA did not consider such payments compensation for services. Initially we note that petitioner presented no evidence corroborating his testimony that Alcoa did not withhold the appropriate taxes from these payments. However, even if we assume that Alcoa did not withhold the appropriate taxes, we do not find this evidence, standing alone, sufficient to establish that the payments in issue constituted additional consideration for petitioner's HCA stock. The testimony of Hatfield, which we found to be credible, candid and forthright, makes it perfectly clear that Alcoa made these payments to petitioner as compensation for his availability for consulting services. The fact that HCA deducted the payments as management fees on Alcoa's 1975 and 1976 consolidated returns corroborates Hatfield's testimony. Consequently, in the absence of more substantial evidence to the contrary, we are satisfied that the August 8 agreement accurately describes the form as well as the substance of the payments in issue.

In Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974), the Supreme Court observed:

> [W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not.

We think this statement accurately addresses the situation presented herein. Although Alcoa and petitioner were free to characterize the payments in issue as consideration for stock, the parties chose to characterize the payments as compensation for services. Having so chosen, petitioner must accept the tax consequence of his choice.

On brief, petitioners alternatively argue that respondent's 1975 and 1976 income tax claims were discharged in bankruptcy. However, subsequent to the trial of this case and the filing of briefs by petitioners, in In re Treister, ___ Bankr. ___ (Bankr. S.D.N.Y. 1985), the United States Bankruptcy Court for the Southern District of New York entered a final judgment that respondent's 1975 and 1976 income tax claims against petitioners were priority claims and, therefore, not discharged in bankruptcy.[5] Thus, because the parties in the instant case are the same as the parties in the above bankruptcy action, the general principle of res judicata precludes petitioners from again arguing that the tax claims in issue were discharged in bankruptcy. Commissioner v. Sunnen, 333 U.S. 591, 597 (1948). Accordingly, respondent's determination is sustained.

To reflect the foregoing,

Decision will be entered
for the respondent.

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[5] In In re Saco Local Development Corp., 711 F.2d 441 (1st Cir. 1983), the First Circuit held that a bankruptcy court's decision that a creditor's claim was entitled to priority status constituted a final decision.

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Ju 11.7/2: 1986-54

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T. C. Memo. 1986-54

UNITED STATES TAX COURT

KENNETH C. KIEHL AND LOIS T. KIEHL, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 29251-83. Filed February 6, 1986.

B. Gray Gibbs, for the petitioners.

Avery B. Cousins, III, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARR, Judge:[*] In his statutory notice of deficiency the Commissioner determined a deficiency of $7,890.71 in petitioners' Federal income tax for the taxable year 1980. During settlement negotiations petitioners learned of respondent's intention to increase the deficiency. Petitioners moved for entry of decision in the amount determined in the notice. The Court granted the motion ex parte. Respondent's subsequent motions to vacate and for leave to amend his answer were granted. By amended answer the determined deficiency was increased to $9,988.71, to take into account self-employment tax omitted from the notice of deficiency.

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[*] By order of the Chief Judge, this case was reassigned to Judge Parr for decision and opinion.

The parties have stipulated that the amount of the increased deficiency is correctly calculated. The only issue for decision is whether the Court properly vacated its decision and permitted respondent to amend his answer.

FINDINGS OF FACT

This case was fully stipulated and submitted under Rule 122,[1] after oral argument. The facts and accompanying exhibits are so found and incorporated herein by this reference.

At the time of filing petitioners, who are husband and wife, resided in Sarasota, Florida.

The procedural history of this case is unusual. A statutory notice of deficiency was mailed to petitioners by the District Director of the Internal Revenue Service, Jacksonville, Florida, on July 13, 1983, determining a deficiency in Federal income tax of $7,890.71. The deficiency arose from the disallowance of petitioners' losses in several partnerships. Petitioners timely filed a petition on October 13, 1983, and respondent timely answered on December 12, 1983.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect for the relevant years, and all Rule references are to the Rules of Practice and Procedure of this Court.

In accordance with section 601.106(a)(1)(i), Statement of Procedural Rules,[2] the case was then referred to the appeals office of the IRS to attempt an out of court settlement. The regulation provides that where a statutory notice is issued by a District Director, "[a]fter the filing of a petition in the Tax Court the Appeals office will have exclusive settlement jurisdiction * * * for a period of 4 months * * * over cases docketed in the Tax Court."

While the case was in the jurisdiction of respondent's appeals office, the appeals officer discovered that the statutory notice of deficiency computation had failed to include self-employment tax in the amount of $2,098. On March 26, 1984 he mailed proposed settlement documents to the petitioners for execution reflecting a deficiency of $9,998.71.

Petitioners objected to the increased deficiency. On July 5, 1984, petitioners filed a motion for entry of decision in the amount of $7,890.71. A copy was served on respondent.

On July 13, 1984, the Court granted the motion, ex parte, finding that a deficiency of $7,890.71 in income taxes was due from petitioners for 1980.

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[2] Reference is to the Code of Federal Regulations, 26 CFR, Part 601, Statement of Procedural Rules.

The record does not show whether jurisdiction had actually transferred from the appeals office to District Counsel when the decision was entered. In any event, entry of the decision apparently caught respondent's counsel by surprise. On August 1, 1984, respondent filed his motion to vacate decision, stating the following reasons:

> (5) Respondent believes that it was petitioners' intent in filing their Consent to Entry of Decision with the Court to close out this matter without the parties agreeing to all the issues now present in the case, and without executing decision documents.
>
> (6) This belief is based on the fact that respondent's Appeals Office had recently informed petitioners that, due to clerical error, respondent's original notice of deficiency had failed to include in its computation the self-employment tax in the amount of $2,098.00, as shown on petitioners' 1980 Form 1040, and that any resolution of the above-entitled case would have to take this additional deficiency amount into consideration.
>
> (7) Respondent further informed petitioners that if petitioners did not now concur with the applicability of the $2,098 self-employment tax, respondent would file an amended answer with the Court setting forth its increased deficiency determination.
>
> (8) Petitioners then filed their Motion for Entry of Decision without first notifying respondent that they were filing said motion.
>
> (9) If this motion is granted, respondent will file a Motion for Leave to File Amendment to Answer and concurrently lodge its Amendment to Answer, asserting an increased deficiency amount based solely on the $2,098.00 self-employment tax.

Petitioners filed a response on August 6, 1984 and requested oral argument. The substance of their argument is that respondent had several months to amend his answer but failed to do so, and should not be allowed to do so after a decision has been entered.

On August 16, 1984 the Court granted respondent's motion to vacate decision and restored the case to the general docket for trial. Respondent duly filed his motion for leave to file amendment to answer on September 13, 1984, petitioners filed a response on September 17, 1984 and the Court granted respondent's motion September 17, 1984.

Respondent's motion for leave to file amendment to answer, to which petitioners take exception, presented the following arguments:

> (1) This case is not presently calendared for trial.
>
> (2) The purpose of the proposed amendment to respondent's answer is to assert the applicable self-employment tax which was not included in the notice of deficiency.
>
> (3) The trial of this case will not be delayed since petitioners will have ample opportunity to address this increased deficiency adjustment prior to trial.
>
> (4) Petitioners' counsel has already been advised by respondent of all the grounds upon which respondent will rely to sustain his determination in this case.

On October 1, 1984 petitioners moved for reconsideration. On October 5, 1984 the case was calendared for trial December 10, 1984. Petitioners' motion for reconsideration was denied October 9, 1984.

The parties have agreed that the correct deficiency is either $7,890.71 or $9,998.71, depending solely upon whether respondent's motion to amend was properly granted.

OPINION

Petitioners argue that the Court abused its discretion in vacating its decision and permitting respondent to amend his answer. They cite respondent's "inexcusable inaction" in failing to amend his answer before the decision was entered. Respondent contends that petitioners knew of respondent's intention to assert an increased deficiency, and filed their motion for entry of decision without prior warning. Respondent implies that petitioners tried to achieve by surprise a result they would not be able to achieve if all the facts were before the Court.

Respondent's error was discovered while the case was under the jurisdiction of his appeals office. The appeals officer called the error to petitioners' attention and expressed an intent to assert an increased deficiency. Proposed settlement documents were mailed to petitioners, who objected. Approximately three months later petitioners filed their motion for entry of decision. Respondent could have (and perhaps should have) attempted to amend his answer during that period, but did not. This fact, standing alone, however, does not show bad faith or dilatory conduct by respondent. Pleadings would have to be filed by respondent's District Counsel, and the record is silent as to when respondent's internal jurisdiction passed from the appeals office to District Counsel. The case had not yet been calendared for trial. Petitioners were on notice of respondent's intent to assert an increased deficiency, and so were not prejudiced by the delay.

Petitioners, on the other hand, were under no duty to forewarn respondent of their intent to seek entry of decision. They timely served respondent with a copy of their proposed consent, which was all the Court's rules require.

The Court granted petitioners' motion ex parte, one week after respondent was served, without knowledge of the error in the statutory notice. The circumstances were called to the Court's attention for the first time by respondent's motion to vacate, which was timely filed.[3]

Under Rule 41,[4] the Court has wide discretion to grant the parties leave to amend their pleadings, and such leave is to be freely given when justice requires. With the Court's permission, amendments may be made as late as the trial itself. In fact, evidence not within the pleadings may be received at trial, where the admission of such evidence would not prejudice a party in maintaining his position on the merits.

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[3] Rule 162 provides: Any motion to vacate or revise a decision, with or without a new or further trial, shall be filed within 30 days after the decision has been entered, unless the Court shall otherwise permit.

[4] Rule 41 provides:
(a) Amendments: A party may amend his pleading once as a matter of course at any time before a responsive pleading is served. If the pleading is one to which no responsive pleading is permitted and the case has not been placed on a trial calendar, he may so amend it at any time within 30 days after it is served. Otherwise a party may amend his pleading only by leave of Court or by written consent of the adverse party; and leave shall be given freely when justice so requires. * * * A

(footnote continued)

Here petitioners have no position to maintain on the merits. They have stipulated that the increased deficiency asserted by respondent is correct if the answer is allowed to be amended. The self-employment tax which respondent failed to take into account in his notice of deficiency required only a mechanical mathematical computation to ascertain. Although respondent has the burden of proof as to increases in a deficiency, Rule 142(a), that burden is met here by a simple computation which petitioners do not challenge.

(footnote continued from previous page)
motion for leave to amend a pleading shall state the reasons for the amendment and shall be accompanied by the proposed amendment.
* * *

(b) Amendments to Conform to the Evidence:

* * *

(2) Other Evidence: If evidence is objected to at the trial on the ground that it is not within the issues raised by pleadings, the Court may receive the evidence and at any time allow the pleadings to be amended to conform to the proof, and shall do so freely when justice so requires and the objecting party fails to satisfy the Court that the admission of such evidence would prejudice him in maintaining his position on the merits.

(3) Filing: The amendment or amended pleadings permitted under this paragraph (b) shall be filed with the Court at the trial or shall be filed with the Clerk at Washington, D.C., within such time as the Court may fix. (Emphasis added.)

Petitioners' reliance on Commissioner v. Long's Estate, 304 F.2d 136 (9th Cir. 1962), is misplaced. In that case, respondent took no action from the time his answer was filed in August 1956 until the trial notice was issued in August 1960, a period of four years. Then he wrote a letter to the taxpayer advising that, depending on information which might be adduced in a related state case, the deficiency might be increased or decreased. After the taxpayer filed a consent to the entry of decision on October 11, 1960, and an order to show cause was issued by the Court, respondent sought leave to amend his pleadings, increasing the deficiency from $2,000 to $48,000 in each of these cases. After a hearing, the Court denied respondent's motion and entered decision for the Commissioner in the amount claimed in the notice of deficiency. Respondent's subsequent motions to vacate were denied. The Court of Appeals affirmed, holding that the Tax Court acted within its discretion under the factual circumstances which were before it.

The circumstances before us are entirely different. Here, respondent through his appeals office conferred with petitioner soon after the case was at issue. When respondent discovered his mistake, he promptly notified petitioner of the exact amount of the increased deficiency and the precise reasons for it. Unlike the circumstances in Long's Estate, here the decision was entered, vacated, and the answer amended, all before a notice setting trial was issued.

Furthermore, in Long's Estate the Court issued an order to show cause and held a hearing, so that respondent had an opportunity to place all of the facts and circumstances before the Court. Here, the Court acted ex parte without knowledge of all the circumstances. In Long's Estate the Commissioner never did present adequate allegations of fact to justify the claim for an increased deficiency. Here the allegation that self-employment tax was omitted, and the amount of the increased deficiency, are clear and undisputed.

Respondent's allegations were clearly spelled out in his motion to vacate, and in the amendment to answer lodged with the Court with respondent's motion for leave to file amendment to answer. Petitioners' claim that respondent's motion failed to state sufficient reasons for the amendment is not well taken.

Accordingly, we are not disposed to change our views. In accordance with the stipulation of the parties, petitioners are liable for a deficiency in income tax for 1980 in the amount of $9,988.71.

Decision will be entered

for the respondent.

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T. C. Memo. 1986-55

UNITED STATES TAX COURT

RONALD E. ALLEN, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17024-84. Filed February 6, 1986.

Ronald E. Allen, pro se.

Joyce Sugawara, for the respondent.

MEMORANDUM OPINION

BUCKLEY, Special Trial Judge: This case was assigned to the undersigned pursuant to the provisions of section 7456(d)(3)[1] and Rules 180, 181 and 182, Tax Court Rules of Practice and Procedure.

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

Respondent determined a deficiency in petitioner's Federal income tax of $4,901 for 1978.

Petitioner resided at 107 San Anselmo, Placentia, California, at the timely filing of the petition.

Some of the facts have been stipulated to by the parties and are so found. The stipulation of facts, with attached exhibits, is hereby incorporated by reference. Petitioner was employed by Western Airlines as a 727 First Officer. Previously, petitioner had served as a pilot in the United States Army and was eligible for veterans' benefits. During 1978, petitioner took two flight training courses for which he paid a total of $13,115.82. Under 38 U.S.C. section 1677(b) (1976) (now repealed), petitioner was reimbursed $11,781.74. Petitioner took an employee business expense deduction of $13,474 on his 1978 tax return. Of that amount, $358 is conceded by petitioner to be an improper deduction. Respondent concedes that the flight training courses maintained and improved skills required in petitioner's employment. Therefore, the unreimbursed amount of $1,334.08 is deductible under section 162(a). The sole remaining issue at trial was the deductibility of the reimbursed amount of $11,781.74.

The legislative history of the pertinent veterans' provisions does not show that Congress intended a veteran to have both an exemption and a tax deduction when reimbursed flight training expenses qualify as deductible business-related education. Manocchio v. Commissioner, 78 T.C. 989, 997 (1982), affd. 710 F.2d 1400 (9th Cir. 1983). Indeed, section 265 was intended to prevent taxpayers from "reaping a double tax benefit by using expenses attributable to tax-exempt income to offset other sources of taxable income." Manocchio v. Commissioner, supra at 997. The Court notes the opinion of the Eleventh Circuit in Baker v. United States, 748 F.2d 1465 (11th Cir. 1984), to the contrary. However, as petitioner is within the Ninth Circuit, we follow our decision in Manocchio as affirmed by the Ninth Circuit. Golsen v. Commissioner, 54 T.C. 742, 756-757 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

Petitioner is, in effect, urging us to apply Rev. Rul. 62-213, 1962-2 C.B. 59, which held "expenses for education, paid or incurred by veterans, which are properly deductible for Federal income tax purposes, are not required to be reduced by the nontaxable payments received during the taxable year from the Veterans' Administration," despite the fact that the ruling was revoked retroactively. Rev. Rul. 83-3, 1983-1 C.B. 72, modified by Rev. Rul. 85-96, 1985-29 I.R.B. 7 (modifying another situation). See Manocchio v. Commissioner, supra at 1000. Before petitioner filed his petition, but after the tax year in question, respondent issued Rev. Rul. 80-173, 1980-2 C.B. 60. That ruling distinguished between reimbursements to veterans for educational benefits and reimbursements made as "living stipends." The former were held to be nondeductible under section 162. We have thoroughly considered whether respondent abused his discretion in applying Rev. Rul. 80-173 retroactively[2] in violation of the taxpayer's right to equal treatment in the application of the tax laws, and decided there was no abuse of discretion. Becker v. Commissioner, 85 T.C. 291 (1985). The facts in Becker are similar in all significant respects to those in petitioner's case.

The Manocchio result controls here for the following reasons. First, it is likely that petitioner would still have taken the courses, even if he had known the deduction was not available due to the tax-free 90-percent reimbursement, the tax deduction for the remaining 10 percent and the improvement in skills required in petitioner's business. Secondly, requiring petitioner to pay the tax owing is not a sufficient injury to militate against the Commissioner's discretion. Nor do we find an unfair discrimination by respondent, as only the inclusion of benefits pertaining to flight training, which are determined by reference to the cost of the training were changed. The taxpayer incurred educational expenses for which tax exempt income was received. Permitting him to deduct the entire educational expense would lead to a double benefit prohibited by section 265. The taxpayer may deduct the nonreimbursed amount. The rationale of section 265, disallowing deductions allocable to income exempt from tax, is a rational basis to treat the reimbursed and unreimbursed amounts differently for tax purposes. See Becker v. Commissioner, supra.

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[2] Rev. Rul. 80-173 was not specifically made prospective, thus it is automatically deemed to have retroactive effect. Manocchio v. Commissioner, supra at 1000.

We conclude that respondent correctly disallowed the deduction claimed for reimbursed flight training expenses.

To give effect to concessions made by the parties,

Decision will be entered under Rule 155.

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T. C. Memo. 1986-56

UNITED STATES TAX COURT

GARY KAVIN BARTEL, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 29977-84. Filed February 6, 1986.

Gary Kavin Bartel, pro se.

Barbara E. Horan, for the respondent.

MEMORANDUM OPINION

FEATHERSTON, Judge: Respondent determined a deficiency in the amount of $578 in petitioner's Federal income tax for 1981. The issues for our decision are:

1. Whether petitioner is entitled to a deduction under section 219(a)[1] for a $1,500 contribution to an Individual Retirement Account (IRA); and

2. Whether petitioner is liable for the 6-percent excise tax under section 4973(a) for excess contributions to an IRA.

All the facts are stipulated.

Petitioner Gary Kavin Bartel resided in Aurora, Colorado, at the time the petition was filed. Petitioner filed an individual Federal income tax return for 1981.

Petitioner was employed by E.F. Hutton and Company (E.F. Hutton[2]) from January 19, 1978 to February 28, 1981. E.F. Hutton maintained a qualified retirement plan under section 401(a) (E.F. Hutton Plan). Petitioner became a member of the E.F. Hutton Plan on February 1, 1979, having met the plan's age and completed service requirements. The E.F. Hutton Plan provides in pertinent part:

> In determining the length of an employee's Service as respects 1975, and each subsequent calendar year, each such calendar year during which the employee did not work for the Company for at least 500 hours shall constitute a break in service. In determining the length of an employee's service, as respects 1975 or any subsequent calendar year, his service preceding a break in service shall be included if:

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

[2] E.F. Hutton will hereinafter be used to describe E.F. Hutton and Company or any one of its subsidiary or affiliate companies, all of which are covered by a common retirement plan.

> (a) the employee completes at least one year of service following the break in service, and
>
> (b) either (i) the aggregate number of years of service prior to such break in service was greater than the number of consecutive one-year breaks in service or (ii) the employee was a vested Member at the time of such break in service, and
>
> (c) such service was not forfeited as the result of a prior break in service.
>
> Credited service shall be granted proportionately in terms of completed months for any part of the calendar year in which the employee became a Member and for any part of the calendar year in which his employment terminates, irrespective of the number of hours of service completed by him in such year.
>
> * * *
>
> Any member whose service is interrupted or terminated and who later becomes an Employee once again shall be eligible to participate as of the date of his rehire provided he completes a year of service after his return. * * *

Participants in the plan received benefits keyed to their years of credited service.

On his 1981 income tax return, petitioner deducted $1,500 for a contribution to an IRA. Respondent disallowed the deduction and imposed an excise tax of $90. Respondent contends that, in 1981, petitioner was an active participant in a qualified plan, and, therefore, was not entitled to a deduction for amounts paid to an IRA under section 219(a).

In general, section 219(a) allows a deduction for contributions made to an IRA. However, under the law in effect in 1981, a taxpayer may not deduct payments to an IRA for a taxable year during which he was an active participant in a qualified plan.

Section 219(b)(2)(A)(i).[3] An individual is an active participant in a qualified plan if he is accruing benefits under the plan, even though he has only forfeitable rights to those benefits and those rights were, in fact, forfeited prior to becoming vested. Hildebrand v. Commissioner, 683 F.2d 57, 59 (3d Cir. 1982), affg. a Memorandum Opinion of this Court; Orzechowski v. Commissioner, 69 T.C. 750, 753 (1978), affd. 592 F.2d 677 (2d Cir. 1979). Because petitioner was a participant in the E.F. Hutton Plan under its express provisions while he was an employee during the first 2 months of 1981, he may not deduct his IRA contribution in that year.

Petitioner contends, however, that because he terminated his employment with E.F. Hutton on February 28, 1981, and has not returned to work for E.F. Hutton, no potential for a double tax benefit existed in 1981. Petitioner urges us to consider the opinion in Foulkes v. Commissioner, 638 F.2d 1105 (7th Cir. 1981), revg. a Memorandum Opinion of this Court. In that case, the taxpayer terminated his employment in May 1975, forfeiting his right to benefits under his employer's qualified pension plan. In addition, the Commissioner had conceded that the break-in-service rules of section 411(a)(6) did not apply to the taxpayer, meaning that should he later return to work for the same employer he would receive no credit under the plan for previously accrued benefits. The court of appeals, emphasizing that the legislative purpose in enacting the "active participant" limitation in section 219(b)(2)(A)(i) was to prevent the potential for a double tax benefit,[4] held that as of the end of the taxable year 1975, the taxpayer had no potential for a double tax benefit and was entitled to a deduction for a contribution to an IRA.

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[3] Sec. 219 has subsequently been amended by sec. 311(a) of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172, 274, to allow a deduction for contributions to an IRA irrespective of participation in a qualified plan. The amendment is effective for taxable years beginning after Dec. 31, 1981.

In the instant case, however, petitioner would be entitled to credit under the plan for previous service if he were to resume employment with E.F. Hutton within the time period provided by the plan's break-in-service rules quoted above. Therefore, the potential for a double tax benefit did in fact exist as of the end of 1981 and, consequently, the rationale adopted by the court of appeals in Foulkes does not apply to petitioner's case. See Horvath v. Commissioner, 78 T.C. 86, 91 (1982); Chapman v. Commissioner, 77 T.C. 477, 481 (1981); Eanes v. Commissioner, 85 T.C. 168, 171 (1985).

We must conclude on the facts of this record that petitioner was an active participant in a qualified plan in 1981 and, as such, was not entitled to a deduction under section 219 for a contribution to an IRA for that taxable year.

Section 4973 imposes an excise tax of 6 percent on "excess contributions" made to an IRA during the taxable year over the amount allowable as a deduction under section 219 for such contributions. Because petitioner is not entitled to a deduction under section 219, the entire $1,500 contribution to an IRA is an "excess contribution" subject to the 6-percent excise tax.

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[4] The double tax benefit which Congress sought to preclude was the potential for an individual to obtain both the tax benefit provided by participating in a qualified plan and the tax benefit allowed to those contributing to an IRA. Chapman v. Commissioner, 77 T.C. 477, 480, n. 4 (1981).

To reflect the foregoing,

Decision will be entered
for the respondent.

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T. C. Memo. 1986-57

UNITED STATES TAX COURT

RIK W. BEIMFOHR and BARBARA A. BEIMFOHR, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 18387-82. Filed February 10, 1986.

Paul J. Quast, for the petitioners.

Marikay Lee-Martinez, for the respondent.

MEMORANDUM OPINION

WRIGHT, Judge*: Respondent determined a deficiency of $701.19 in petitioners' Federal income tax for the year ending

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* By order of the Chief Judge this case was reassigned from Judge Perry Shields to Judge Lawrence A. Wright.

December 31, 1979. The issue for decision is whether petitioners may deduct Arizona State and Mesa City transaction privilege taxes under section 164.[1]

The facts have been stipulated and are so found. The stipulation of facts and exhibits thereto are incorporated herein by this reference.

Rik W. Beimfohr and Barbara A. Beimfohr (hereinafter "petitioners") resided in Mesa, Arizona, when the petition herein was filed.

On April 23, 1979, petitioners entered into a purchase contract with Leathers Enterprises ("Leathers") to purchase a new, completed custom built home. The sale was finalized on October 25, 1979. On March 14, 1980, Steve Leathers, president of Leathers, informed petitioners by letter that they had paid $1,799.98 in State of Arizona sales taxes on the home purchased in 1979, and that this amount was deductible on their 1979 Federal income tax return.

Leathers is a general contractor in the business of building completed single family homes and selling those homes to the consuming public. As such, Leathers is subject to the transaction privilege taxes imposed by the State of Arizona and the City of Mesa. Title 42, Chapter 8, Article 1, of the Arizona

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year here in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

Revised Statutes, in effect in 1979, imposed a transaction privilege tax on prime contracting in the aggregate amount of 4 percent on the gross proceeds of sales, excluding the sales price of land and an amount equal to 35 percent of gross proceeds of sale in lieu of labor employed in construction, improvements, or repairs. Chapter 10, Section 5-10-3 of the Code of the City of Mesa, Arizona, in effect in 1979, imposed a transaction privilege tax on every person engaging or continuing within the City of Mesa in the business of contracting in an amount equal to 1 percent of the gross proceeds of sales, subject to a deduction in the amount of 35 percent from the gross proceeds of sales in lieu of any labor, shop, or subcontractor deductions.

On their joint Federal income tax return for 1979, petitioners deducted $1,799.98 as sales tax paid on the purchase of a new home. Respondent disallowed this deduction.

The sole issue for decision is whether petitioners may deduct Arizona State and Mesa City transaction privilege taxes under section 164. The same issue was addressed by this Court in Karpinski v. Commissioner, T.C. Memo. 1983-50. In Karpinski, we held that State of Arizona and City of Tempe transaction privilege taxes paid by a contractor engaged in the business of building and selling completed homes were not deductible under section 164(a)(4) as general sales taxes by the purchasers of one such home. The transaction privilege tax imposed by the City of Tempe at issue in Karpinski is identical to the transaction privilege tax imposed by the City of Mesa at issue herein. See Tempe City Code Chapter 33, Art. II, Div. 2, sec. 33-16.9, as amended by Ordinance No. 569.4, December 1, 1977; Mesa City Code, Chapter 10, sec. 5-10-3(a)(7), as amended by Ordinance No. 1697, May, 1983. Because there is no significant difference between the facts in the instant case and those in Karpinski, we see no reason to depart from our holding in that case.

Petitioners herein, however, argue alternatively that the transaction privilege taxes imposed on the builder of their home are deductible as compensating use taxes under section 164(b)(2)(D) or as real property taxes under section 164(a)(1).

Petitioners first attempt to characterize the transaction privilege taxes as compensating use taxes defined in section 164(b)(2)(D).[2] They argue that because no sales tax is paid by contractors at the time construction materials are purchased, the transaction privilege taxes imposed on the contractor's gross profits serve as a means of compensating the State of Arizona and the City of Mesa for this loss of revenue, and, therefore, that the purchasers of the completed structure which incorporates the materials should be entitled to a compensating use tax deduction for such tax. We disagree.

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[2] Section 164(b)(2)(D) provides:

> A compensating use tax in respect of an item shall be treated as a general sales tax. For purposes of the preceding sentence, the term "compensating use tax" means, in respect of any item, a tax which --
>
> (i) is imposed on the use, storage, or consumption of such item, and
>
> (ii) is complementary to a general sales tax, but only if a deduction is allowable under subsection (a)(4) in respect of items sold at retail in the taxing jurisdiction which are similar to such item.

A compensating use tax is not deductible if it is imposed at a rate other than the general rate of tax. Sec. 1.164-3(i)(2), Income Tax Regs. The general rate of tax is defined as "the one rate which qualifies a tax in a taxing jurisdiction as a general sales tax because the tax is imposed at such one rate on a broad range of classes of items." Sec. 1.164-3(g)(4), Income Tax Regs. The State of Arizona and the City of Mesa have no general sales tax. Industrial Uranium Co. v. State Tax Commission, 95 Ariz. 130, 387 P.2d 1013, 1014 (1963). Each jurisdiction, however, levies a series of transaction privilege taxes. Ariz. Rev. Stat. Ann. sec. 42-1301 et. seq. (1980) (hereafter A.R.S.); Mesa City Code Chapter 10, sec. 5-10-3. These taxes are imposed upon the gross proceeds of sales by retailers engaged in the business of selling tangible personal property at the rates of 2 percent and 1 percent by the State of Arizona and the City of Mesa, respectively. A.R.S. sec. 42-1312.A; Mesa City Code Chapter 10, sec. 5-10-3(A)(8). The taxes at issue herein are imposed at the rates of 4 percent and 1 percent by the State of Arizona and City of Mesa, respectively, on the gross proceeds of a general contractor less certain deductions.[3] A.R.S. sec. 42-1309 through 42-1371; Mesa City Code, Chapter 10, sec. 5-10-3. Petitioners acknowledge, on brief, that it is difficult to determine whether the amount of tax paid by the contractor under these sections is the same as would have been imposed had the building materials been purchased at retail by a non-contractor. They argue, however, that the deductions which the city and state statutes provide for labor costs and the deduction for the cost of the land under the state statute are intended to permit the tax paid by the contractor to approximate the tax which would have been imposed had the building materials been purchased at retail by a non-contractor. Petitioners cite no authority for this assertion, nor have we found any. There is no reason to assume that the amount of gross proceeds remaining, after deductions for labor costs and land costs, bears any relation to the cost of the materials used to construct petitioners' home.

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[3] The Arizona Revised Statutes, as amended and in effect in 1979, imposed a transaction privilege tax on prime contracting at the rate of 4 percent of the gross proceeds of sales, excluding the sales price of the land (not to exceed fair market value) and an amount equal to 35 percent of the gross proceeds of sales in lieu of labor costs. A.R.S. secs. 42-1309 through 42-1371. The builder of petitioners' home apparently deducted actual labor costs, rather than the 35 percent of gross proceeds permitted by statute. The parties do not suggest, nor do we find, that this error has any bearing on the issues before us.

The Mesa City Code, as amended and in effect in 1979, imposed a transaction privilege tax on prime contracting at the rate of 1 percent of the gross proceeds of sales, less a deduction of 35 percent, in lieu of labor costs. Mesa City Code Chapter 10, sec. 5-10-3.

Deductions are a matter of legislative grace; petitioners bear the burden of proving entitlement to the claimed deductions. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). The Supreme Court has stated that "[m]en must turn square corners when dealing with the government." Rock Island, A & M RR v. United States, 254 U.S. 141, 143 (1920). Petitioners in this case have failed to do so. The compensating use tax provision was designed to permit a jurisdiction to impose a tax, equivalent to a retail sales tax, on items brought in from another jurisdiction. S. Rept. No. 830, 88th Cong., 2d Sess. (1964), 1964-1 C.B. (Part 2) 505, 560; H. Rept. No. 749, 88th Cong., 1st Sess. (1963), 1964-1 C.B. (Part 2) 125, 175. Petitioners' attempt to characterize the transaction privilege taxes at issue herein as compensating use taxes confounds the statutory scheme. Further, petitioners have not shown that the transaction privilege taxes are imposed at the general rate of tax. Therefore, they are not entitled to deduct these taxes as compensating use taxes under section 164(b)(2)(D).

Petitioners next argue that the transaction privilege taxes are deductible under section 164(a)(1) as real property taxes. Real property taxes are defined as taxes imposed on interests in real property and levied for the general public welfare. Sec. 1.164-3(b), Income Tax Regs. This Court stated in Karpinski, however, that "[t]he transaction privilege taxes at issue herein are excise taxes on the privilege or right to engage in an occupation or business * * *." T.C. Memo. 1983-50. The transaction privilege taxes at issue herein are not imposed on interests in real property, but on the gross proceeds derived from the business of contracting. Dennis Development Co. v. Dept. of Revenue, 122 Ariz. 465, 595 P.2d 1010 (1979); State Tax Commission v. Ranchers Exploration and Development Corp., 22 Ariz. App. 480, 528 P.2d 866 (1974); A.R.S. sec. 42-1310.2. Therefore, petitioners are not entitled to a deduction for real property taxes.

Finally, we note that even if the transaction privilege taxes were properly classified as compensating use taxes or, alternatively, taxes on an interest in real property, petitioners would not be entitled to a deduction. Taxes are deductible only by the person on whom they were imposed. Sec. 1.164-1(a)(5), Income Tax Regs. In determining the person entitled to deduct the tax, Federal courts must look to state law. Armentrout v. Commissioner, 43 T.C. 16, 19 (1964). Under Arizona law, the transaction privilege tax is the personal liability of the seller. New Cornelia Cooperative Mercantile Co. v. Arizona State Tax Commission, 23 Ariz. App. 324, 533 P.2d 84, 87 (1975); A.R.S. sec. 42-1301; Mesa City Code, Chapter 10, sec. 5-10-1. Because the transaction privilege taxes herein were imposed on the contractor, and the liability for those taxes remained solely that of the contractor, petitioners are not entitled to a deduction therefor.

For the reasons stated above,

Decision will be entered for the respondent.

COMPLETED 32

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T. C. Memo. 1986-58

UNITED STATES TAX COURT

MAURICE M. WEIKEL AND LORRAINE H. WEIKEL, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17990-81. Filed February 10, 1986.

In 1967, petitioner, a dentist, acquired a patent for a dental amalgam called Dispersalloy. In September 1973, petitioner formed a corporation, Dispersalloy, Inc., and transferred his patent to it in exchange for all its stock. In January 1974, petitioner and Johnson & Johnson executed an agreement and Plan of Reorganization of the Dispersalloy Corporation under which petitioner transferred all of his stock in Dispersalloy, Inc. to Johnson & Johnson in exchange for Johnson & Johnson stock.

Held: Dispersalloy, Inc. was organized for a substantial business purpose.

Held, Further: The exchange of Dispersalloy, Inc. stock by petitioner for stock of Johnson & Johnson qualifies as a tax-free reorganization under sections 354(a)(1) and 368(a)(1)(B), I.R.C.

Held, Further: The step-transaction doctrine does not apply to make the transaction taxable. West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966), distinguished.

ORIGINAL

Laurence L. Pillsbury, for the petitioners.

Karen Nicholson Sommers, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DRENNEN, Judge: Respondent determined a deficiency in petitioners' Federal income tax in the amount of $1,750,273 for the taxable year 1974. The issue remaining for our decision[1/] is whether petitioners' transfer of stock from Disperalloy, Inc. for stock in Johnson & Johnson qualifies as a tax-free reorganization under sections 354(a)(1)[2/] and 368(a)(1)(B).

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and joint exhibits are incorporated herein by this reference.

Maurice M. and Lorraine H. Weikel (petitioners)[3/] are husband and wife who were legal residents of Las Vegas, Nevada,

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[1/] Respondent had also originally disallowed for lack of substantiation a deduction of $20,845 in 1974 as a carryback of an investment tax credit from petitioners' 1977 taxable year. After the trial was held in this case, the record was left open for thirty days to allow petitioners time to present evidence substantiating their 1977 investment tax credit. Respondent now concedes this issue.

[2/] All section references are to the Internal Revenue Code of 1954, as amended, and in effect during the taxable years at issue. All rule references are to the Tax Court Rules of Practice and Procedure.

[3/] All references to "petitioner" refer to Maurice M. Weikel.

at the time they filed their petition in this case. They filed a joint Federal income tax return for 1974[4] with the Internal Revenue Service Center in Ogden, Utah.

On January 25, 1980, the parties executed an agreement extending the statute of limitations for the respondent's determination of a deficiency for the 1974 taxable year until June 30, 1981. This agreement is effective only if there is an omission from petitioners' gross income which is in excess of 25 percent of the amount of gross income reported on petitioners' 1974 return.[5]

Acquisition of Dispersalloy

During the years at issue petitioner was employed as a dentist. While working as a dentist, he began research on a new dental amalgam as he was disappointed in the life of his dental restorations. A dental amalgam is an alloy used in the restoration of teeth. His research subsequently led to his development of a stronger, more effective dental amalgam that he began using with some of his patients. He sought a patent for the alloy only to find out that a patent had already been applied for. The patent had been purchased from its owner by Western Metallurgical Ltd. (Western). Petitioner obtained a licensing agreement from Western on October 19, 1967, which gave him the exclusive right to manufacture, market and sell the alloy in the U. S. under the trade name of "Dispersalloy." Later on November 15, 1967, this agreement was expanded to include North, South, and Central America, but not Canada.[6] The agreement with Western did not require petitioner to make a cash payment; however he was to make royalty payments to Western based upon the amount of Dispersalloy used and sold. The agreement did not allow petitioner to transfer his rights to manufacture and market Dispersalloy without first obtaining Western's consent.

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[4] Petitioners also filed a timely Form 3468 for the taxable year 1977 showing a tentative investment tax credit of $22,744. On or about June 22, 1979, petitioners filed an amended return for 1974 showing a carryback of investment tax credit of $20,845 from 1977 and claiming a refund in 1974 for that amount. As noted supra at n. 1, respondent at first denied this refund claim for lack of substantiation, but now concedes the issue since petitioner has provided evidence of substantiation.

[5] If the transaction here involved does not qualify as a tax-free reorganization petitioners' gross income was in excess of 25 percent of the gross income reported on their return for 1974. Therefore, the agreement to extend the statute of limitations will be effective.

Petitioner did not market Dispersalloy extensively when he first acquired the patent rights. At first he just used the alloy with his own patients. In March of 1970, petitioner asked his attorney, Robert Lesh (Lesh), to file articles of incorporation for a company called American Silver and Mercury Producers (ASMP). Lesh advised petitioner to consult Philip Altfest (Altfest) about the tax aspects of incorporating and running a corporation. Altfest was an attorney with a background in accounting who specialized in corporate taxation. ASMP was established as a cash basis taxpayer. Its articles were filed on March 3, 1970, in the state of California. ASMP's articles stated that its purpose was to "engage primarily in the specific business of manufacturing of dental alloys and mercury." On March 31, 1970, ASMP's directors adopted bylaws, elected officers, and authorized the issuance to petitioners of ten shares of common stock for a consideration of $10. However, no assets were ever transferred to ASMP, nor did it ever conduct any business. ASMP's corporate charter was suspended on April 2, 1973 for nonpayment of California franchise taxes. Petitioner stated that he did not activate ASMP because the manufacture of Dispersalloy did not produce immediate profits as he had anticipated. Manufacturing the alloy proved costly, generating substantial losses. Petitioner chose instead to continue his operation as a sole proprietor, rather than as a corporation so that he, individually, could benefit from the losses incurred.[7]

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[6] In addition to holding the rights to market Dispersalloy, petitioner held the patent rights on Disposacap. Disposacap was a prepackaged product of alloy and mercury. It was conveniently packaged in a small plastic capsule that was easily mixed and then placed in the patient. The rights to Disposacap were transferred to Dispersalloy, Inc. along with those of Dispersalloy.

Petitioner wanted to expand his manufacture of Dispersalloy. At a dental convention prior to 1973, he discussed Dispersalloy with a classmate of his who then contacted Unitek Corporation (Unitek). Unitek and petitioner reached an agreement whereby petitioner would manufacture the alloy and Unitek would market it. Shortly thereafter, petitioner leased a manufacturing plant in El Cajon, California. Unitek encountered problems in marketing the alloy and was unable to purchase from petitioner the volume to which they had agreed. Hence, petitioner voided his agreement with Unitek and began to market Dispersalloy on his own sometime in August of 1973. Sales of Dispersalloy increased in 1973 after the publication of several research papers that discussed it favorably.

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[7] In addition to Dispersalloy, petitioner salvaged and marketed low grade dental alloys under the fictitious business name "N K Metals, Inc." Petitioner's net profits for ASMP and N K Metals during the years he acted as a sole proprietor were as follows:

Year	Net profit or loss
1970	(8,517)
1971	(93,803)
1972	38,878
1973 (10 months)	121,977

Negotiations with J&J

In April of 1973 petitioner was approached by Dr. Martin Stein (Stein), vice president in charge of business development for the Dental Products Division of Johnson & Johnson (J&J). J&J was a New Jersey corporation engaged in the manufacture and marketing of various dental care products whose stock was listed on the New York Stock Exchange.[8] J&J had learned about Dispersalloy at a dental convention earlier in April where they had also met Bruce Ady, one of petitioner's employees, and expressed a desire to learn more about the alloy. Stein met again with petitioner on April 25, 1973, to discuss the possibility of an arrangement with petitioner that would allow J&J to market Dispersalloy. In May 1973 petitioner visited the J&J manufacturing plant in New Jersey. On June 1, 1973, Stein wrote to petitioner requesting additional information about ASMP. This information was supplied to Stein on June 15, 1973.

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[8] During its negotiations with petitioners, J&J utilized the following individuals:

Name	Position
R. L. MacKenzie	President
Martin Stein	Vice president
A. F. Ring, Jr.	Vice president
George Frazza	Attorney

We do not differentiate which individuals were present on J&J's behalf at the different stages in the negotiations principally because the record is unclear and the parties differ in their recollections.

Sometime in late July of 1973 petitioner learned that Pennwalt Corporation, an organization that manufactured and distributed dental products through its S.S. White Division, claimed that it held some patent rights to a product that was the subject matter of a paper entitled "Dispersion Hardening of Amalgams" by W.V. Youdelis and D.B.K. Innes given at a meeting in St. Louis of the International Association for Dental Research in March of 1962. W. V. Youdelis was the inventor and original patentee of Dispersalloy. This prompted S.S. White to claim that petitioner's patent was invalid. Petitioner discussed this problem with J&J's patent attorney who indicated that it was possible that there was a problem with petitioner's patent.

As sales of Dispersalloy increased, petitioner decided that it was time to revitalize ASMP. He met with Altfest in August of 1973 to discuss the tax benefits of marketing Dispersalloy through a corporation. At that time petitioner had been contacted by J&J but no real negotiations had taken place. Altfest prepared a memorandum for a negotiation session to be held between petitioner and J&J on August 9, 1973, in San Diego (San Diego meeting). At the San Diego meeting, petitioner decided, at J&J's suggestion, to incorporate under the name of "Dispersalloy, Inc." instead of revitalizing ASMP. This decision was made because it was felt that Dispersalloy was a well-known name and would be more effective for marketing purposes than would revitalizing ASMP.[9]

Discussions at the San Diego meeting centered around a joint venture proposal by petitioner whereby petitioner would incorporate and manufacture Dispersalloy while J&J would have the sole right to market Dispersalloy. J&J would receive an option to buy all of the Dispersalloy, Inc. stock after three years. J&J was also to make a loan to Dispersalloy, Inc.[10]

A second meeting was held between representatives from J&J and petitioner on August 22, 1973, in New Jersey (New Jersey meeting). At this meeting the J&J representatives rejected the joint venture arrangement proposed by petitioner and suggested instead that the transaction be structured as a pooling of interests.[11] J&J told petitioner that they wanted him to incorporate Dispersalloy to help effectuate this pooling of interests. J&J would then exchange its stock for stock of Dispersalloy, Inc. The parties discussed a base price for Dispersalloy, Inc. of $3.5 million[12] plus an additional sum for Dispersalloy, Inc.'s assets. Royalties were also discussed with a figure of around $500,000 being considered but the length of prepayment was not settled. A problem was encountered in the negotiations due to the uncertainty concerning the validity of petitioner's patent. J&J refused to close the transaction until an agreement was obtained from the owner of the patent in Canada. However, J&J stated that they would purchase Dispersalloy regardless of the patent's validity with the understanding that the amount of royalties petitioner would receive would depend upon whether J&J was the only one allowed to market Dispersalloy. Also considered at the New Jersey meeting was whether the transaction would be effective as a tax-free reorganization if it was structured according to J&J's demands. Altfest and petitioner originally thought that the exchange of J&J stock for stock of Dispersalloy, Inc. might produce a taxable capital gain to petitioner. Petitioner therefore requested that J&J assist him in a private placement for some of the stock that he was

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[9] There was also testimony at trial by Altfest that the name "Dispersalloy, Inc." was chosen in order to protect the trademark or trade name. However, this comment was not discussed further.

[10] The record does not reveal the purpose of this loan. We assume that it would be to assist in the manufacture of Dispersalloy.

[11] A "pooling of interests" is a term of art used by the accounting profession to describe the situation where a merger or consolidation of two business combinations occurs and the assets, liabilities, and shareholders's equity of the two combinations form a single, large, economic unit. Seidler and Carmichael, Accountant's Handbook, Vol. 2, at 30 (6th ed. 1981). A pooling of interests is advantageous for a large company that wants to acquire a smaller subsidiary because with a pooling of interests the subsidiary can continue its separate identity for accounting purposes. The parent receives the subsidiary's assets at book
(footnote continued)

(footnote continued from previous page)
value with no step-up in basis. In addition, the parent would not have to capitalize the acquired corporation's goodwill.

[12] This figure did not include the sale of tangible assets but did include amounts for goodwill.

receiving in the exchange. In this way petitioner would be able to pay the capital gains tax incurred on the transaction by selling some of the J&J stock shortly after the exchange occurred.[13] Throughout the negotiations both parties were aware that any agreement that was reached was subject to the approval of J&J's Board of Directors, and that a final definitive agreement would have to be drawn up and signed by both parties before anyone was legally bound. In addition, a final condition to J&J's purchase of Dispersalloy was the receipt by J&J of a favorable accounting opinion concerning the pooling of interests.

Throughout the negotiations petitioner was concerned about agreeing to let J&J market Dispersalloy. He was concerned about whether J&J would try to improve the quality of Disperalloy, or would produce it as a poorer alloy in order to save money. He was also concerned that he was not receiving sufficient royalties and that J&J was lying to him about the sufficiency of his patent. While negotiations continued with J&J, petitioner contacted several other companies including 3M, Unitek, Columbus Dental, Warner Lambert, and L. D. Cock with regard to the manufacturing and marketing of Dispersalloy. Prior to the time he was contacted by J&J, petitioner had not thought seriously about selling his interest in Dispersalloy. After he met with

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[13] There is some dispute between the parties as to whether an agreement was ever reached in regard to private placement of the J&J stock. This dispute has no effect upon our ultimate decision.

J&J he decided that Dispersalloy would be more successful if it were marketed by someone with more money and more experience in such matters.

After the New Jersey meeting, Altfest advised petitioner that he should incorporate Dispersalloy whether or not the transaction with J&J was finalized. He stated that based upon the negotiations with J&J it was clear to him that whoever purchased Dispersalloy would be interested in a pooling of interests which required that Dispersalloy be incorporated. In addition, Altfest advised petitioner that since he had begun to make a profit in manufacturing Dispersalloy it would now be advantageous to incorporate.

On September 13, 1973, articles of incorporation were filed with the State of California for Dispersalloy, Inc.[14/] The corporation's purpose as stated in its articles was to "engage primarily in the specific business of manufacturing of dental alloys and mercury." On October 10, 1973, the Board of Directors of Dispersalloy, Inc. adopted bylaws, elected officers, and authorized the issuance of stock. However, because petitioners' books and records were in poor condition, it was not until November 2, 1973, that petitioner transferred his Dispersalloy assets to Dispersalloy, Inc. and it assumed all of his

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[14/] Western consented to petitioner's transfer of his rights to market Dispersalloy to a corporation to be formed by petitioner. J&J reached an agreement with Western regarding this transfer on October 9, 1973. J&J had to arrange for the additional rights to market Dispersalloy in Canada and the eastern hemisphere.

obligations and liabilities related to that business. The patent rights to Dispersalloy, with a zero cost basis, were included in the transfer.[15] Altfest wanted Dispersalloy to be an accrual basis taxpayer with its taxable year ending either October 31, or November 30 for business purposes. [16] Dispersalloy, Inc. did not adopt a pension or profit-sharing plan but it did have a health insurance plan.

On or about October 10, 1973, Altfest was contacted by J&J's representatives who stated that J&J could not agree to pay royalties to petitioner because it would interfere with their plan to have a pooling of interests. Negotiations continued on this point and resulted in J&J agreeing to pay petitioner a lump sum for his license to market Dispersalloy instead of paying him royalties over a twelve year period as originally discussed.

As part of the negotiation process, J&J sent one of its employees into petitioner's plant under a secrecy agreement to view the manufacture of Dispersalloy. The negotiations were prolonged, prompting Altfest to send a letter to J&J stating that if a definitive agreement were not reached with petitioner by

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[15] None of the assets of N K Metals were transferred to Dispersalloy, Inc. Petitioners' total cost basis in the transferred assets was $395,695. The liabilities assumed by Dispersalloy, Inc. amounted to $38,742. Petitioners received 200 shares of Dispersalloy, Inc. common stock for their transferred assets.

[16] Altfest mentioned the possibility of deferring some income until the next calendar year if Dispersalloy was on an accrual basis.

October 12, 1973, then the J&J employee would have to leave petitioner's plant. On October 4, 1973, J&J responded to this letter by sending petitioner a document described as a "boilerplate reorganization agreement" used by J&J in stock-for-stock transactions. J&J advised petitioner to review the document in order to save time if an agreement was soon reached on the material terms of the transaction.

J&J representatives next contacted petitioner at a dental convention in Houston on or about October 31. At this meeting, J&J made a final proposal of a lump sum payment to replace the royalty arrangement. Petitioner accepted this offer after discussing it with Altfest. Negotiations continued on the price for Dispersalloy, Inc.'s tangible assets and its other inventory, the amount of stock that petitioner could sell after the transaction was closed to pay the tax on the transaction, and who was to pay for the cost of placing the stock. It was later decided that petitioner could sell $2.8 million of the stock he received.[17]

On November 7, 1973, J&J sent a letter to Bruce Ady (Ady), one of petitioner's employees offering him a job in the event J&J was able to reach a final agreement with Dispersalloy, Inc. Ady was in charge of research and development at Dispersalloy, Inc. Petitioner had intended to discharge Ady in early August but retained him at J&J's request. Ady was employed by J&J on December 15, 1973, and remained in their employ until the spring of 1974.

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[17] There is a dispute between J&J and petitioner concerning who was to pay for the costs of the placement of the stock. This dispute has no affect upon our ultimate decision.

On or about November 15, 1973, J&J appointed several individuals to handle the manufacturing and marketing of Dispersalloy, including a product director, a controller of accounting, a purchaser, and an engineer. Also in mid-December, Martin Stein (Stein), one of J&J's vice-presidents, moved to San Diego to learn about the manufacture of Dispersalloy from petitioner.

Petitioner and Altfest met in early December to discuss fully the financial aspects of the entire transaction with J&J. Altfest opined that despite the close proximity of the incorporation of Dispersalloy, Inc. to the transaction between Dispersalloy, Inc. and J&J, if there was no binding agreement prior to the incorporation of Dispersalloy, Inc. to sell the stock of J&J received in the exchange, then the transaction would qualify as a tax free exchange. Petitioner then suggested that the provision in the agreement allowing petitioner to sell some of the stock through private placement be eliminated and that J&J pay petitioner the additional amount it would incur in the private placement of petitioner's stock. J&J at first disagreed with petitioner's proposal but after considerable discussion finally agreed to give petitioner additional stock worth $300,000 to $400,000. This additional stock was intended to reimburse petitioner for the tax he would have to pay if he immediately sold some of the J&J stock. J&J's representatives stated that up to this point in the negotiations they viewed the transaction as taxable to petitioner.

On January 18, 1974, an agreement was executed between petitioners and J&J entitled "AGREEMENT AND PLAN OF REORGANIZATION OF THE DISPERSALLOY CORPORATION." Under the agreement, petitioners were to exchange all of the stock of Dispersalloy, Inc. for an amount of J&J common stock to be determined at a later date. An amendment to this agreement was executed on March 1, 1974, which changed the agreed method of valuing inventory, work in progress, and raw materials. On March 1, 1974, the transaction was closed with petitioners delivering all of the outstanding Dispersalloy stock to J&J. J&J then delivered 48,898 shares of its unregistered voting common stock to petitioners on April 30, 1974. The parties agreed that the average of the closing prices for a share of J&J common stock on the New York Stock Exchange between March 4, 1974, and March 15, 1974, would be taken as the value of the J&J stock for purposes of determining the number of shares of J&J stock to be issued to petitioner. This average price was determined to be $108.2875 per share.

The shares of J&J common stock received by petitioners were not registered for distribution under the Securities Act of 1933. J&J assumed no obligation to so register the shares. Ten percent of the shares received by petitioners was placed in escrow with National Bank of New Jersey to be held for 23 months as security for petitioners' obligation to indemnify J&J from liabilities of Dispersalloy that occurred after the transaction was executed.

The stock received by petitioners was valued at $4,368,058.[18] This value was computed by taking the value of $108.94 per share, which was the mean trading price per share of J&J common stock on April 1, 1974, the date J&J was to deliver the stock to petitioners, and reducing this value by 18 percent to $89.33 per share, due to the restrictions on petitioners' shares.

On March 1, 1974, Altfest delivered an opinion to J&J which was required as part of the parties' agreement of sale, which stated in substance that Dispersalloy, Inc. was a corporation duly organized, validly existing and in good standing under the laws of the State of California and that the authorized capital stock of Dispersalloy, Inc. consisted of 2,500 shares of common stock, 200 shares of which were outstanding and validly issued, fully paid and nonassessable.

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[18] Petitioners have sold 58 percent of the J&J stock that they originally received. A three for one stock split of the J&J stock occurred in 1981. Petitioners now hold 61,194 shares of J&J stock or 20,398 on a pre-split basis of the original 48,898 shares.

Dispersalloy, Inc. filed a U.S. Corporate Income Tax Return for a first fiscal year commencing November 1, 1973 and ending February 28, 1974. The return showed gross sales of $2,171,245, gross profit of $971,359, taxable income of $455,524, and tax of $211,844.

J&J treated the transaction with petitioner as a taxable purchase of assets placing the fair market value of petitioner's assets received on its books as the value of what J&J received in the exchange. J&J also treated the patent for Dispersalloy as having a basis of around $3-3.5 million and attempted to amortize this cost over the life of the patent. This position was attacked by the IRS. J&J paid the tax determined and filed a claim for refund. The IRS has continued to challenge J&J's depreciation of the patent. J&J has continued to file refund claims in response to the IRS challenges. All of these refund claims are being held in abeyance pending the disposition of this case.

J&J continued to operate Dispersalloy, Inc. as a wholly owned subsidiary for two years and seven months after the agreement with petitioners was closed. Dispersalloy was produced in the plant leased by petitioner in El Cajon, California, and also in the J&J plant in New Jersey. Dispersalloy, Inc. was merged into its parent, J&J, on September 30, 1976.

OPINION

The issue in this case is whether petitioners' exchange of stock of Dispersalloy, Inc., for stock of J&J was a non-taxable transaction under sections 354 and 368(a)(1)(B), or whether the exchange should be "stepped together" with the incorporation of Dispersalloy and characterized as a taxable sale of Dispersalloy assets by petitioner for J&J stock pursuant to the step-transaction doctrine.

The parties herein have negotiated an agreement extending the time for assessment of a deficiency beyond its typical three year period. See sec. 6501(a). This agreement is effective only if respondent can prove that petitioners have omitted an amount that is in excess of 25 percent of their gross income for the taxable year 1974. See sec. 6501(e); Reis v. Commissioner, 1 T.C. 9 (1942). The burden of proof is therefore on respondent to establish both that the amounts of income which were not reported were properly includible in gross income and that an amount in excess of twenty-five percent of the amount of gross income shown on the return was omitted. Easton v. Commissioner, a Memorandum Opinion of this Court dated Feb. 5, 1943. For there to be an omission herein of an amount in excess of twenty-five percent of petitioners' gross income, the transaction at issue must be taxable.

Section 354 provides as a general rule that no gain or loss is to be recognized if stock or securities in a corporation which is a party to a reorganization are exchanged pursuant to a plan of reorganization for stock or securities in another corporation also a party to the reorganization. A reorganization is defined in section 368(a)(1)(B) as:

> the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

What constitutes control for purposes of section 368(a)(1)(B) is defined in section 368(c) as:

> the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

On the surface this transaction qualified as a reorganization; J&J acquired all of the stock of Dispersalloy, Inc. in exchange solely for a part of its voting stock. But, stock for stock exchanges between corporations have been subjected to additional scrutiny pursuant to a judicially created doctrine called the step-transaction doctrine. Under the step-transaction doctrine an analysis is made of the separate steps of a transaction to determine whether each step should be accorded independent legal significance or whether the steps should be treated as related steps in one unified transaction, and "stepped together" to produce the actual result. King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969). This analysis is undertaken in order to determine the substantive realities of a transaction and hence its tax consequences. Gregory v. Helvering, 293 U.S. 465 (1935); King Enterprises, Inc. v. United States, supra.

The step-transaction doctrine remains a somewhat elusive principle. However, there have been attempts to establish some sort of coherence as to the manner in which it is applied. Hence, courts have established several tests in determining whether the doctrine is applicable. However as one court noted, "these tests are notably abstruse -- even for such an abstruse field as tax law." Redding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir. 1980), revg. 71 T.C. 597 (1979), cert. denied 450 U.S. 913 (1981).

The first test involves an examination of the intention of the parties to determine what result the parties were seeking when the transaction was undertaken. Mintz and Plumb, Step Transactions in Corporate Reorganizations, 12 N.Y.U. Institute on Federal Taxation 247, 251 (1954). This test is often called the "end result" test. King Enterprises, Inc. v. United States, supra; Redding v. Commissioner, supra. Under this test, the parties' intended result would have the same tax effect regardless of the steps taken to reach the result. Mintz and Plumb, *supra*.

A second test has been called the "interdependence test." Mintz and Plumb, *supra*. This test examines the transaction to determine whether the successive steps were so interdependent that the action would have been fruitless without completing all of the steps. Mintz and Plumb, *supra*, quoting Paul & Zimet, Step Transactions, in Selected Studies in Federal Taxation (2d Series 200 (1938)); *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520, 524 (7th Cir. 1982), revg. 76 T.C. 972 (1981).

Finally an additional test called the "binding commitment test" is often used. This test is viewed as more restrictive than the other two and involves a determination as to whether after the first step is taken in a transaction there is a binding commitment to complete the later steps. *Commissioner v. Gordon*, 391 U.S. 83 (1968); *McDonald's Restaurants of Illinois v. Commissioner*, *supra* at 525. One court has suggested that the binding commitment test is only applicable where a substantial period of time has passed between the steps that are subject to scrutiny. Redding v. Commissioner, supra. Courts will often, in addition to the tests noted above, examine the timing of the transaction at issue.[19]

Petitioners contend that their incorporation of Dispersalloy followed by an exchange of all of the stock of Dispersalloy, Inc. for an amount of J&J stock was a tax-free "B" reorganization under sections 354 and 368(a)(1)(B). Petitioners argue that the step-transaction doctrine is inapplicable to their transaction because Dispersalloy, Inc. was not a sham corporation; it was in operation conducting business for almost three years after the exchange of stock occurred. In addition, petitioners contend that the incorporation of Dispersalloy and the exchange of stock were two separate transactions since petitioners did not execute a definitive agreement for the exchange of stock until several months after the incorporation of Dispersalloy, and the incorporation would not have been fruitless if the exchange of stock had not occurred. Moreover, petitioners contend that they had formulated the intent to incorporate Dispersalloy regardless of their negotiations with J&J since Dispersalloy had begun to produce a profit. In the alternative petitioners contend that even if the step-transaction doctrine is applicable any gain recognized on the exchange of stock was recognized in 1973, a year that is not before this Court, instead of 1974.

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[19] For example, if two transactions occur within an hour of each other it would be reasonable to assume that the second transaction was prearranged given the fact that it would be difficult to conceive and execute the second transaction in the interval of time available. Mintz and Plumb, supra.

Respondent contends that petitioners' transfer of his sole proprietorship assets to Dispersalloy, Inc., was one step in a prearranged integrated plan to transfer his assets to J&J in exchange for stock. Therefore respondent contends the incorporation of Dispersalloy and the exchange of stock should be stepped together to demonstrate that the transaction was in essence a purchase of petitioners' assets by J&J, not a tax-free reorganization.

The question presented is a factual one; therefore a careful examination must be made of the transaction at hand. After making such an examination, we agree with petitioners.

We must first determine whether the incorporation of Dispersalloy was an event with independent economic substance. Respondent does not contend that the incorporation of Dispersalloy was a sham; rather, respondent argues that the incorporation lacked economic substance independent from the later exchange of stock. Respondent urges us to find that the incorporation of Dispersalloy was simply one link in a chain of steps to transfer the assets of petitioners' sole proprietorship to J&J for stock. Respondent cites West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966), and Rev. Rul. 70-140, 1970-1 C.B. 73, as support for his contentions.

In West Coast Marketing Corp., this Court held that the taxpayer formed a corporation called Manatee solely for the purpose of transferring to it the title to certain properties in exchange for Manatee's stock. An agreement for the sale of the properties to an unrelated corporation, Universal, had been detailed in a letter dated April 16, 1959. Thereafter, on April 30, 1959, Manatee was formed and received title to the properties noted. All of Manatee's stock was then transferred to Universal. Universal liquidated Manatee on December 18, 1959.

While the transaction in West Coast Marketing Corp. and the transaction herein do contain similarities, there are several crucial distinctions that demonstrate why the step-transaction doctrine is not applicable in petitioners' situation. In West Coast Marketing Corp. when Manatee was formed the sale of the taxpayer's properties to Universal was imminent and was in fact prearranged. Universal had made a formal offer to the taxpayer. The sale had been approved by Universal's Board of Directors. All that remained was for the taxpayer to obtain a release of the mineral rights on the properties.

In contrast, in the instant case petitioners never arranged a sale of their sole proprietorship assets to J&J. The transaction was from the beginning a stock for stock exchange. This exchange was not finalized until January 18, 1974. Dispersalloy was incorporated on September 13, 1973. When Dispersalloy was incorporated, negotiations with J&J were still in progress. The parties first discussed a joint venture arrangement, then an exchange of stock with a private placement, and then a pure exchange of stock. Petitioners' agreement with J&J remained uncertain. Petitioner expressed reservations about reaching an agreement with J&J because he was unsure that J&J would commit itself to improving the amalgam Dispersalloy. Any agreement that was reached between petitioner and J&J remained tentative until it was approved by J&J's Board of Directors and J&J had received a favorable accounting opinion about its plan to have a pooling of interests.

Petitioners also differ from the taxpayer in West Coast Marketing Corp. in the purpose behind their incorporation. In West Coast Marketing Corp., Manatee was not formed for a business purpose but was instead formed when the sale of land to Universal was imminent to serve as a conduit for passing title to Universal. Manatee did not engage in any business activities and was dissolved shortly thereafter.

In contrast, petitioner formulated the intent to manufacture Dispersalloy in corporate form as early as 1970 when he first filed the articles of incorporation for ASMP. He did, however, operate ASMP as a sole proprietorship instead of as a corporation because the manufacture of Dispersalloy did not prove profitable at first and he wanted to, individually, take advantage of ASMP's losses. When Dispersalloy began to make a profit petitioner again thought of operating in corporate form to gain the tax benefits that were not afforded to a sole proprietorship, and he decided to revitalize ASMP. Petitioner stated that in his negotiations with J&J they suggested that he incorporate to facilitate their attempts at seeking a pooling of interests, and that Dispersalloy would be a more beneficial name for the corporation. Altfest stated that when petitioner decided to incorporate it was for several reasons including the following: 1) that J&J wanted Dispersalloy to incorporate to help effectuate J&J's pooling of interests; 2) that he and petitioner felt that any other company that sought to manufacture Dispersalloy would want a pooling of interests which necessitated that the business be incorporated; and 3) that, due to Dispersalloy's profits, sound tax planning required that the business be operated in corporate form. After Dispersalloy was incorporated and its stock exchanged for stock of J&J it continued in operation for almost three years. Based upon the above discussion, we do not find West Coast Marketing Corp. to be controlling as regards the characterization of petitioners' transaction.

Rev. Rul. 70-140, 1970-1 C.B. 73, is also distinguishable from petitioners' situation. In Rev. Rul. 70-140, A, an individual owned all of the outstanding stock of X corporation. A also operated a sole proprietorship. Y, an unrelated corporation, made an agreement with A that A would transfer the assets of his sole proprietorship to X for X stock. A then transferred all of his X stock to Y for Y voting stock. The ruling holds that the two steps of the transaction were part of a prearranged integrated plan and were thus "stepped together" to reflect the true nature of the transaction which was a sale by A of his assets to Y followed by a transfer of these assets by Y to the capital of X.

This ruling is similar to the facts of West Coast Marketing Corp. and is thus distinguishable from petitioners' transaction for some of the same reasons. The facts of the ruling illustrate a transaction that was conducted pursuant to a prearranged plan with X serving as a mere conduit for the transfer of A's assets from X to Y in order to attempt a tax-free transaction. As noted previously, petitioners did not incorporate and then conduct an exchange of stock with J&J pursuant to a prearranged plan. Petitioners had independent valid business purposes for incorporating. Moreover, Dispersalloy, Inc. was not a mere conduit. Dispersalloy, Inc. operated for almost three years after the agreement with J&J was finalized.

Respondent makes much of the fact that at one point the parties to the transaction all viewed it as taxable. Respondent also points out that J&J continued to view the transaction as taxable even after the private placement provision was eliminated. We have carefully considered the testimony of J&J's representatives and have determined that it does not alter our decision. The testimony of the J&J representatives is colored by the fact that the tax treatment they were seeking in the transaction is opposite to that of petitioners.

Viewing the facts of the instant case in light of the step-transaction doctrine we are not persuaded that the doctrine is applicable under any of its various tests. Under the "end result" test, for reasons previously discussed, we are not convinced that when petitioners incorporated Dispersalloy they intended for the end result of their transaction to be a sale of their assets to J&J for stock. Petitioners had expressed an intent to incorporate their business as early as 1970 when they incorporated ASMP. They stated that they decided during their negotiations with J&J that they would incorporate whether or not they ultimately reached an agreement with J&J because they wanted to obtain the tax benefits that were inherent in a corporation and they wanted to make Dispersalloy attractive to any publicly held corporation that might be interested in a pooling of interests. Accordingly, we are not convinced that it was petitioners' purpose in incorporating Dispersalloy, Inc. to arrange a tax-free sale of their assets for J&J stock.

Under the interdependence test it is clear that petitioners intended to incorporate whether or not they finalized an agreement with J&J for an exchange of stock. The incorporation of Dispersalloy would therefore not have been fruitless without the exchange of stock. Accordingly, petitioners' transaction does not run afoul of the interdependence test.

Moreover, petitioners did not have a binding commitment with J&J to exchange the stock of Dispersalloy for the stock of J&J prior to the incorporation of Dispersalloy. The incorporation of Dispersalloy was a separate transaction. It was not until sometime after the incorporation of Dispersalloy that petitioners reached a definitive agreement with J&J to exchange stock. Therefore, once they had incorporated Dispersalloy petitioners were free to carry on the manufacture of Dispersalloy.

After a consideration of the relevant authorities we have determined that the transaction in the instant case is controlled by our decision in Vest v. Commissioner, 57 T.C. 128 (1971), affd. in part, revd. on another issue 481 F.2d 238 (5th Cir. 1973), cert. denied 414 U.S. 1092 (1973).

In Vest, the taxpayers organized a corporation, V Bar, for the purpose of correcting certain title problems in some land interests and to develop the mineral interests in the land. At the time the corporation was formed the taxpayers were unaware that an exchange of stock was being contemplated between V Bar, and Standard, an unrelated corporation that was interested in a lease of the oil and gas rights on taxpayers' land. The taxpayers' attorney had discussed the possibility of an exchange of stock with a representative from Standard but had not informed the taxpayers of this possibility. V Bar was incorporated on July 21, 1965. On August 25, 1965 a plan of reorganization was signed by Standard and V Bar that provided for an exchange of stock. V Bar did not engage in any business operations and was dissolved shortly after the reorganization occured. Despite the close proximity of the incorporation of V Bar, to the exchange of V Bar stock for Standard stock, we held that the step-transaction doctrine was inapplicable. We held thusly because there was a business purpose for the formation of V Bar, i.e., to develop the mineral rights of the taxpayers' properties and to resolve the title problems inherent in those properties. Vest v. Commissioner, supra at 143-146.

It is equally true in the instant case that petitioners had a business purpose for incorporating Dispersalloy -- a purpose that was formulated as early as 1970. That purpose was to market Dispersalloy in corporate form and to obtain the tax benefits of a corporate form that were unavailable to a sole proprietorship. Moreover, in the event that Dispersalloy, Inc. should reach an agreement with another corporation for the manufacture of Dispersalloy, then Dispersalloy, Inc. would be in corporate form which would facilitate a pooling of interests. The fact that Dispersalloy, Inc. was incorporated for a business purpose is evidenced by the fact that it continued conducting business operations for almost three years after the exchange of stock with J&J occurred.

We therefore conclude that Dispersalloy, Inc. was organized for substantial business purposes. Hence, we agree with petitioner[20] that the transaction herein was effective as a tax-free reorganization.

The parties have stipulated that petitioners are entitled to a deduction in 1974 for an investment tax credit carryback from 1977 in the amount of $20,845. It is so found.

Decision will be entered under Rule 155.

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[20] Since we have agreed with petitioners' main contention, we need not reach their alternative argument and therefore express no opinion on this issue.

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T. C. Memo. 1986-59

UNITED STATES TAX COURT

STEVEN HOWARD PARKIN AND LINDA MARY FALES PARKIN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 16169-84. Filed February 10, 1986.

Gregory K. Wanless and Robert K. Strouse, for petitioners.

Erin Collins, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

AARONS, Special Trial Judge: This case was assigned to Special Trial Judge Aarons pursuant to the provisions of section 7456(d)(3) and Rules 180, 181 and 182[1].

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

ORIGINAL

Respondent determined a deficiency in petitioners' Federal income tax for 1981 in the amount of $6,973, together with an addition to tax under section 6651(a) in the amount of $997. After concessions set forth in the Stipulation of Facts, the remaining issues are:

(1) whether Parkin Laboratories, Inc. qualified as a valid subchapter S corporation in 1981;

(2) whether petitioners are entitled to an investment tax credit in 1981; and

(3) whether petitioners are liable for the delinquent filing addition under section 6651(a).

To the extent set forth in the Stipulation of Facts, the facts are so found except as qualified below. At the time the petition was filed herein, petitioners resided in Riverside, California.

Petitioner Steven H. Parkin (hereinafter referred to as "petitioner" unless otherwise indicated) is employed in the Department of Chemistry at the Irvine campus of the University of California, and also is employed on night duty at Mission Community Hospital. Commencing in 1979, petitioner endeavored to establish himself in the operation of a laboratory for the manufacture of products used in anesthesia. He established Pharmachem Laboratories in 1979, but that business was abandoned shortly thereafter.

On August 18, 1980, petitioner caused a new corporation, Parkin Laboratories, Inc. (hereinbelow referred to as "Labs") to be incorporated in Delaware. Labs was formed to manufacture anesthetic products. Although the Stipulation of Facts states that Labs began doing business on August 18, 1980, this "fact" was flatly contradicted by petitioner on cross examination. He testified (referring to 1981):

> *** since at that time, all we were doing was preparing documentation for the FDA, there effectively was no business for Parkin Laboratories, Inc., per se. All the business that was transacted, was transacted in the form of a sole proprietorship. We bought and sold some lab equipment.

But in apparent contradiction to that testimony, the Stipulation of Facts recites:

> Parkin Laboratories, Inc., substantiated their 1981 taxable year expenses which resulted in a loss in the amount of $28,837.

Petitioners carried their pro rata share of that loss, in the amount of $26,968, on to their personal return, which was an amended return on Form 1040X for the year 1981.

Prior to the formation of Labs, petitioner had procured a "package" of forms and instructions from The Company Corporation of Delaware. The package contained a minute book and minute forms, corporate charter, articles and by-laws, stock certificates, stock transfer log, and a Form 2553 for the election of Subchapter S, as well as a form for qualifying the stock under section 1244. The agenda prepared by petitioner for the first meeting of the Board of Directors included as one of its items: "Qualify Corporation as a 'Subchapter S' Corporation". The minutes of that meeting (on September 18, 1980) reflect approval of Subchapter S status and direct that the officers take the necessary steps. The minutes of the special meeting of stockholders (November 10, 1980) are silent relative to Subchapter S.

At some time in 1980 petitioner had discussed with a prospective business associate the tax advantages of a Subchapter S corporation and had indicated his intention of qualifying Labs under Subchapter S.

Petitioner may have prepared the Form 2553 in September 1980. He may have had it "xeroxed" at some time and may have placed it in an envelope addressed to the Internal Revenue Service Center in Philadelphia --- so addressed, he stated, because Labs was a Delaware corporation. From the time that the envelope was assertedly placed in the outgoing box there is an absence of direct testimony or other proof as to its actual mailing. However, it was part of the routine duties of Jeffrey Parkin (petitioner's son) to pick up the mail each day from the outgoing box and deposit it in the Post Office mail box.

When a Form 2553 is received by the Philadelphia Service Center, it goes through several steps, including assignment of an employer identification number if none has been previously assigned. When the form has been finally accepted, it is so stamped and a copy of the accepted form with accompanying letters is mailed to the taxpayer. If the Form 2553 is incomplete, the original is returned to the taxpayer with instructions (after the Service Center has assigned the identification number).

The records of the Philadelphia Service Center do not reflect that a Form 2553 was ever processed for Labs. Nor did petitioner or Labs receive any documents from the Service Center relating to the Form 2553.

On November 10, 1980, petitioner made gifts of Labs stock to his son Jeffrey, his daughter Stacy, and his then fiancee Linda Fales. Each gift was 250 shares. None of the donees filed consents to Labs' Subchapter S status.

Petitioners filed their original joint return for 1981 at an undisclosed time after its due date. That return did not pass through losses from a Subchapter S corporation. The notice of deficiency was issued February 27, 1984. On March 3, 1985, petitioner Linda Mary Fales Parkin executed and filed a Subchapter S corporate return on Form 1120S for Labs' taxable year 1981. That return reflected that the Small Business election had been made in August 1980. The record does not reflect whether or not any corporate returns were filed for Labs for years subsequent to 1981. The March 3, 1985 return states that the business activity of Labs was "modification/rebuilding scientific instruments and measuring devices". On April 9, 1985, petitioners filed their Form 1040X, amending their 1981 return and claiming the $26,968 pass through loss from a Subchapter S corporation, i.e. Labs.

The original 1981 individual return was prepared by Tony Rose, a CPA. Petitioner's testimony was that he informed Mr. Rose of Labs' status as a Subchapter S corporation but that because, as set forth above, Labs had transacted no business in 1981, Mr. Rose told petitioner not to file a Subchapter S return.[2] According to petitioner the Form 1120S, filed March 3, 1985, was suggested by an Internal Revenue Service auditor, along with an amended individual return for 1981.

The investment tax credit (for new section 38 property) in the amount of $787 claimed by petitioners on their original return, related to a computer, printer and software. The only disputed aspect of this issue is: who first placed these assets in service? The Court finds that the assets in question were used by petitioner, individually, for business purposes on several business projects in the spring of 1981, prior to the incorporation of Labs and the transfer of these assets at the end of 1981 to Labs by way of a contribution to capital.

No proof was offered by petitioners in respect to the delinquency addition under section 6651(a).

The following are our ultimate findings of fact:

1. Petitioners have not established the mailing of the Form 2553, Election by a Small Business Corporation.

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[2] At another point in the trial, petitioner testified (with respect to Labs): "The first sale of anything we had was in August or September of 1981."

2. Petitioners have established that they were the original users of the property as to which an investment tax credit was claimed.

3. Petitioners have not established reasonable cause and absence of willful neglect for failure to timely file their 1981 return on Form 1040.

The principal issue in this case is whether (as petitioners contend) Labs made an effective election in 1980 under section 1372 to be treated as an electing small business corporation under Subchapter S. Section 1372(c)(3) provided that such election shall be made in the manner prescribed by the Regulations. Section 1.1372-2, Income Tax Regs., as in effect in 1980, provided that the election should be made by filing Form 2553 (which also includes a form for the required shareholders' consents).

The filing of the election form is, of course, critical in determining whether Labs achieved Subchapter S status. Whether or not Form 2553 was filed is a question of fact. On questions of fact (with certain exceptions not relevant here), there is a presumption of correctness in respondent's determination, and the taxpayer-petitioner has the burden of proof in rebutting that presumption. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a).

The Court has concluded that petitioners' proof on this issue did not suffice to rebut that presumption. There was no direct testimony that the Form 2553 was actually mailed. Contrast Mitchell Offset Plate Service, Inc. v. Commissioner, 53 T.C. 235 (1969); Leve v. Commissioner, T.C. Memo. 1985-255 and Zaretsky v. Commissioner, T.C. Memo. 1967-247, relied upon by petitioners. Even though we were to accept at face value the testimony that the Form was prepared and positioned for mailing[3], the only fact that supports actual mailing is the routine of Jeffrey Parkin. Fully counterbalancing such routine is the routine of the Philadelphia Service Center, pointing to the conclusion that the Form or a copy would have been returned one way or another to petitioners if it had indeed been received by that Center. Then, adding to the counterbalancing in respondent's favor are the inconsistencies between the Stipulation of Facts and petitioner's testimony as to when Labs really began to do business, the inconsistencies within petitioner's own testimony on this score, and the inconsistency as to the month in 1980 when the Subchapter S election was allegedly mailed. The total picture, accented particularly by the three year delay in filing the 1120S and the 1040X forms for 1981 (after the issuance of the notice of deficiency), lends itself to the conjecture that the Subchapter S status of Labs was not perfected (in petitioner's mind) until, in hindsight in 1985, the advantages of petitioner's present position became apparent.

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[3] There was no proof as to the use of the proper address in the alleged mailing of Form 2553 to the Philadelphia Service Center. Nor was anything done to secure tangible evidence of mailing (such as a receipt from the Postal Service).

We need not resolve such conjecture because all the cumulative doubts we have as to what really happened with the Form 2553 add up to zero doubt in the mind of the Court as to petitioners' failure to carry their burden of proof on this issue.[4]

With respect to the disallowance of the investment tax credit, our findings dispose of the purely factual question which is the only area of disagreement between the parties. The original use of the property commenced with petitioners and they are entitled to the investment tax credit. See section 48 (b)(2).

Petitioners offered no proof as to the delinquency addition under section 6651(a). They have failed to carry their burden of proof on this issue. See Abramo v. Commissioner, 78 T.C. 154, 162-164 (1982).

To reflect the foregoing, as well as the concessions set forth in the Stipulation of Facts,

Decision will be entered
under Rule 155.

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[4] Respondent also appeared to be taking the position at trial that any election under Subchapter S would have been terminated by the failure of the three donee shareholders to file consents. That position would be untenable. The Revenue Act of 1978 (Sec. 343(b)(2), Pub. L. 95-600, 92 Stat. 2844), changed the rules on this score and disqualifies a Subchapter S corporation only if new shareholders affirmatively refuse to consent within 60 days after acquiring their stock. Section 1372(e)(1)(A).

COMPLETED 11

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T. C. Memo. 1986-60

UNITED STATES TAX COURT

LOUIS PHILIP ZOLLO, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8821-83. Filed February 10, 1986.

Held: Petitioner is not entitled to a charitable contribution deduction in excess of that allowed by respondent; petitioner is liable for an addition to tax under section 6653(a); and damages are awarded under section 6673.

Louis Philip Zollo, pro se.

Mary P. Hamilton, for the respondent.

ORIG L

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined a deficiency in petitioner's Federal income tax for the calendar year 1981 in the amount of $8,494 and additions to tax pursuant to section 6653(a)(1)[1] and (2) in the amounts of $424.70 plus 50 percent of the interest payable on an underpayment of $8,494. During trial and on brief, respondent also requested an award of damages pursuant to section 6673. The issues before us for decision are:

(1) Whether petitioner is entitled to a deduction for charitable contributions of $25,230 allegedly made to the Universal Life Church, Inc.;

(2) whether petitioner is liable for the additions to tax pursuant to section 6653(a)(1) and (2); and

(3) whether an award of damages pursuant to section 6673 is appropriate.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by reference. Petitioner resided in Worcester, Massachusetts at the time his petition was filed.

Petitioner holds Bachelor of Science and Masters degrees in business administration from Clark University. During the taxable year 1981, he was employed by Astra Pharmaceutical Products, Inc. as the director of materials and by Honeywell Information Systems Inc. as a manager of software development.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

On his 1981 Federal income tax return, petitioner reported wages of $46,904. His wife, Cheryl G. Zollo, was unemployed during 1981.[2]

On June 2, 1981 petitioner opened a bank account in the name "Universal Life Church, Inc." (ULC) on which he, his wife, and Robert A. LeClerc were authorized signators. The address of this purported ULC was petitioner's home. During 1981 checks totaling $21,810 drawn by petitioner on his personal checking and savings accounts and made payable to ULC were deposited in this account. Throughout 1981, petitioner retained complete control over the ULC account. The extent of this control is evidenced by the fact that most, if not all, checks drawn on the account were deposited in petitioner's personal checking and savings accounts or were cashed by petitioner for his personal use. For example, from September 15 through December 1981, $10,210 from petitioner's personal accounts was deposited in the ULC account. During the same time period, checks drawn on the ULC account payable to petitioner totaled $8,875. There is no evidence that the Universal Life Church, Inc. of Modesto, California, which at this time was recognized by respondent as an exempt organization, authorized the opening of this account, had any control over it, or asserted any claim to funds deposited in the account.

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[2] The statutory notice of deficiency was addressed to both petitioner and Cheryl G. Zollo. However, Mrs. Zollo is not a petitioner in this proceeding.

The statutory notice of deficiency disallowed deduction of petitioner's alleged contributions to ULC of $25,230. Petitioner argues that respondent has previously recognized ULC as a charitable organization and, therefore, deductions to that organization are deductible under section 170.

The petition in this case was filed on April 23, 1983. On January 18, 1984 respondent wrote petitioner advising him that alleged charitable contributions to the ULC in Modesto, California or a chapter of that church had been addressed by the Court numerous times and said cases had been decided in favor of the Government. In this letter respondent cited 24 such cases and enclosed copies of two opinions. Respondent further advised petitioner that he was considering requesting the imposition of damages under section 6673. Imposition of such damages was raised by respondent at the close of trial on May 3, 1984.

In preparing for trial respondent made both formal and informal discovery requests on petitioner. Petitioner failed to substantively respond to these requests. Petitioner's position throughout discovery and trial preparation was that relevant books and records were in the hands of the ULC of Modesto, California and could not be provided to respondent. Consequently, respondent subpoenaed a number of banks at which petitioner had maintained accounts during 1981 for relevant records. Petitioner repeatedly objected to receipt into evidence of the bank records obtained pursuant to these subpoenae.

OPINION

The first issue for decision is whether petitioner is entitled to deduct the amount of $25,230 designated as a charitable contribution to the ULC on his 1981 joint Federal income tax return. Section 170(c) allows a deduction for charitable contributions where the taxpayer establishes each of the following: (1) that the contributions were actually made; (2) that they were made to a qualified, tax-exempt organization; and (3) that no part of the net earnings of such organization inured to the taxpayer's personal benefit. Davis v. Commissioner, 81 T.C. 806 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985).[3]

The burden of proof is upon petitioner to establish his entitlement to a deduction under section 170 as such deductions are matters of legislative grace. Deputy v. du Pont, 308 U.S. 488 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Petitioner has failed to satisfy his burden of proof as to each of the above requirements of section 170.

It is well settled that where a taxpayer retains dominion and control as to the future disposition of purportedly contributed property, no charitable contribution has been made. Davis v. Commissioner, supra at 817. Petitioner did not part with control over any funds allegedly deposited into this bank account. He merely transferred them from his personal bank accounts to another account he controlled.

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[3] See also Weaver v. Commissioner, T.C. Memo. 1985-473; Kent v. Commissioner, T.C. Memo. 1984-451; Johnson v. Commissioner, T.C. Memo. 1984-164; Leslie v. Commissioner, T.C. Memo. 1984-61.

Even if we found that petitioner actually made a gift, he has not met his burden of proving that the contributions were made to a proper donee. Petitioner maintains that "proof was offered and provided to the I.R.S. showing that the Universal Life Church, Inc. is an entity recognizable for tax purposes as being separate and distinct from the petitioner" and is a "tax exempt organization listed in the cumulative list of organizations published by the U.S. Government." Although the ULC of Modesto, California had tax-exempt status during 1981[4], the record contains no evidence that petitioner made any donation to this organization. This Court has repeatedly held that an exemption such as that granted to the Modesto, California organization is not a group exemption. Hall v. Commissioner, 729 F.2d 632, 634 (9th Cir. 1984), affg. a Memorandum Opinion of this Court; Davis v. Commissioner, supra at 815; McGahen v. Commissioner, 76 T.C. 468, 481 (1981), affd. without published opinion 720 F.2d 664 (3rd Cir. 1983); Basic Bible Church v. Commissioner, 74 T.C. 846, 855-856 (1980), affd. sub nom. Granzow v. Commissioner, 739 F.2d 265 (7th Cir. 1984).[5] The record contains no evidence that a local chapter of the Modesto ULC was ever authorized or established in petitioner's home. Even if such a chapter had been formed, petitioner would still be required to demonstrate that it was a tax-exempt organization. He has failed to do so.

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[4] The Internal Revenue Service has revoked its determination that the Universal Life Church, Inc. of Modesto, California was a qualified organization under sec. 170(c)(2). Announcement 84-90, 1984-36 I.R.B. 32 (Sept. 4, 1984).

[5] See also Gaster v. Commissioner, T.C. Memo. 1984-590; Bradfield v. Commissioner, T.C. Memo. 1984-481; Hoskinson v. Commissioner, T.C. Memo. 1984-400.

Petitioner has also failed to satisfy the third prong for deductibility--providing proof that his ULC, if one existed, was operated exclusively for exempt purposes. The facts prove the contrary. An organization is not operated exclusively for exempt purposes if its net earnings inure in whole or in part to the benefit of any individual. Any net earnings of the ULC bank account opened by petitioner would inure solely to his benefit, given his complete control over the disposition of funds in that account.

Petitioner asserts that receipts adequately substantiate his purported charitable contributions to ULC and his claimed deduction is, therefore, appropriate. The purported receipts were excluded from evidence as unreliable hearsay and were contradicted by bank records showing that petitioner retained control over, and personal use of, the funds in question. This Court has repeatedly held that such ULC receipts are not admissible. See Hall v. Commissioner, supra at 634-635; Kalgaard v. Commissioner, 764 F.2d 1322 (9th Cir. 1985), affg. a Memorandum Opinion of this Court; Davis v. Commissioner, supra at 814-815. As the receipts were not received in evidence, petitioner's reliance on them is misplaced.

During trial and on brief, petitioner raised the argument that he is a duly ordained minister of the ULC and as such is entitled to benefits available to ordained ministers of church corporations pursuant to sections 107 and 119.[6] Petitioner argues that he received a housing allowance from the ULC to defray his expenses and in lieu of any compensation. This argument was apparently advanced to explain the flow of funds from the ULC account to petitioner's personal accounts. The charade that petitioner employed to generate purported charitable contributions must be examined in light of the practical facts of this case. No money or other assets existed to pay a housing allowance to petitioner before his purported "contributions." His transfer of funds to the ULC account in order to pay himself a housing allowance is not a deductible charitable contribution because the transfer was made "with the expectation of receiving a commensurate benefit [i.e., the housing allowance] in return * * *." Sedam v. United States, 518 F.2d 242, 245 (7th Cir. 1975); Singer Co. v. United States, 449 F.2d 413, 422-423 (Ct. Cl. 1971). Further, the record does not support a finding that any local chapter existed at petitioner's home or that he was a member or minister of any ULC church. We find petitioner's belated contention that he received a housing allowance as a minister of ULC a totally spurious argument.

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[6] Sec. 107 deals with exclusion from gross income by a minister of the gospel of the rental value of parsonages and sec. 119 deals with meals or lodging furnished for the convenience of the employer.

Petitioner also contends that "the U.S. Tax Court does not have jurisdiction over religious matters as presented in this case and should not put itself in the position of judging what is or is not an acceptable religion or religious practice." Petitioner's theme of religious persecution is evident in his refusal to cooperate by providing respondent with any information or documents sought during discovery. Petitioner invoked the jurisdiction of this Court to determine his tax deficiency, or lack thereof. In determining whether he is entitled to the claimed charitable contributions, we have not been required to pass upon whether any rights under the First Amendment to the Constitution are violated. Nothing affecting petitioner's personal beliefs or religious learnings are involved in this case. What is involved is petitioner's claim of a deduction for purported donations from his personal bank accounts to a ULC bank account he opened and retained control of. Requiring a taxpayer to show that an organization to which he claims to have made charitable contributions meets the requirements of section 170(c) is not in any way related to the protection afforded by the First Amendment. However, if in attempting to show that an organization meets the requirements of section 170(c) it is necessary to demonstrate the religious activities of that organization, such an incidental burden on religion is clearly permissible. See Hall v. Commissioner, 729 F.2d 632, 635 (9th Cir. 1984), affg. a

Memorandum Opinion of this Court; Unitary Mission Church v. Commissioner, 74 T.C. 507, 514 (1980), affd. without published opinion 647 F.2d 163 (2nd Cir. 1981).

In addition to the ULC contributions, petitioner claimed a deduction for cash contributions to other charities in the amount of $180. Respondent allowed $100 of this amount. Petitioner failed to submit any evidence regarding this issue and we conclude that the excess claimed deduction for contributions to other charities must be disallowed.

The next issue we must resolve is petitioner's liability for additions to tax under section 6653(a). Petitioner bears the burden of proof to show error in respondent's determination that such additions to tax are appropriate. Bixby v. Commissioner, 58 T.C. 757 (1972); Rule 142(a). He presented no evidence to show that his underpayment of tax was not due to negligent behavior, and, to the contrary, much of his involvement with the ULC account apparently was designed to manufacture bogus tax deductions. Petitioner is an intelligent, educated individual who could not reasonably have believed that by shuffling income between bank accounts totally within his control he could generate charitable contribution deductions. Accordingly, we sustain respondent's determination that petitioner is liable for an addition to tax pursuant to section 6653(a)(1) and that the entire amount of petitioner's underpayment was due to negligence for purposes of section 6653(a)(2).[7]

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[7] Sec. 6653(a)(2) is effective for calendar years beginning with 1981. Pub. L. 97-34, sec. 722(b)(1), 95 Stat. 342.

The final issue for decision is whether damages should be awarded to the United States pursuant to section 6673. This section provides for an award of damages in an amount up to $5,000 "[w]henever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless * * *." A review of the record herein convinces us that petitioner has abused the process of this Court and wasted its resources and those of respondent in bringing a case which is frivolous and groundless. Prior to trial, petitioner was advised that respondent intended to request damages under section 6673 and was provided with relevant case cites and opinions demonstrating the lack of merit in his arguments. He chose to proceed and must now bear the consequences of that choice. We award damages to the United States under section 6673 in the amount of $5,000.

To reflect the foregoing,

Decision will be entered for the respondent.

COMPLETED 9

Ju 11.7/2:1986-61

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T. C. Memo. 1986-61

UNITED STATES TAX COURT

GEORGE E. ALFORD, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9483-83. Filed February 10, 1986.

Joe Lee Wyatt, for the petitioner.

Gary F. Walker, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GOFFE, Judge: The Commissioner determined a deficiency in petitioner's Federal income tax of $41,355.40 for the taxable year 1981. The first issue for decision is whether the statutory notice of deficiency issued by the Commissioner showing unreported income earned by petitioner is arbitrary. If we find that the notice of deficiency was not arbitrary, we must decide whether the Commissioner's determination of the unreported income earned by petitioner is incorrect.

ORIGINAL

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and the attached exhibits are incorporated by this reference.

George E. Alford (petitioner) resided at the Federal Correctional Institute in Talladega, Alabama, at the time he filed his petition in this case. He did not file Federal income tax returns for the taxable years 1975 through 1981.

Petitioner had no legal sources of income from 1975 through the year in issue. During this period of time, petitioner had a substantial drug addiction. He supported himself during this period through the sale of illegal drugs and gambling winnings.

On March 17, 1981, petitioner and his wife were stopped by local police while traveling by automobile in Greenville, Mississippi. Police searched petitioner and his car, a 1975 Cadillac, and discovered the following:

- 2.0 pounds cocaine
- .25 pounds hashish
- 2.0 pounds marijuana
- 8 guns
- various drug paraphernalia including
    - scales
    - pocket microscope
    - strainers
- several pieces of gold jewelry and gold and silver coins
- $14,060 in U.S. currency

Petitioner's wife also had several pieces of jewelry and $260 in U.S. currency in her possession. The cocaine had a wholesale fair market value of $64,000. The values of the hashish and marijuana were $322 and $500, respectively.

Petitioner was arrested on felony charges of possessing illegal drugs with intent to sell. He subsequently pleaded guilty to the charges and was sentenced to 20 years in prison.

The cocaine, hashish, marijuana, and cash discovered by police upon petitioner's arrest were acquired with his earnings from the sale of drugs and gambling during the taxable year 1981. No part of the value of the illegal drugs or the cash represents borrowed amounts or assets acquired in prior years. At the time of his arrest, petitioner maintained two bank accounts with balances of $100 and $1,000. He also maintained safety deposit boxes at several banks throughout the country. One safety deposit box contained $8,000 in cash and some silver coins at the time of his arrest.

On January 27, 1983, the Commissioner issued a statutory notice of deficiency in which he determined that petitioner had unreported income for the period from January 1, 1981, to March 26, 1981, totaling $79,621.60. The unreported income was calculated as follows:

George Edward Alford
Source and Application of Funds for
Period 1-1-81 to 3-26-81

Application of Funds:

Cash	$14,060.00
Cocaine, two pounds	64,000.00
Hashish, one quarter pound	320.00
Marijuana, two pounds	500.00
Living Expenses Per Bureau of Labor Statistics	741.60
Total Application of Funds	$79,621.60

Sources of Funds:

No Known Sources of Income	$ -0-
Total Sources of Income	$ -0-
Applications Exceed Sources	$79,621.60
Adjusted Gross Income	$79,621.60

OPINION

At the outset, we must address petitioner's claim that the statutory notice of deficiency issued by the Commissioner is arbitrary because it lacks sufficient evidentiary support. Ordinarily a determination of deficiency by the Commissioner enjoys a presumption of correctness. Furthermore, in a case before this Court, the burden of proof and the burden of going forward with the evidence ordinarily rest with the petitioner. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142, Tax Court Rules of Practice and Procedure. Where, however, it is demonstrated that the statutory notice of deficiency is arbitrary and excessive, the presumption of correctness evaporates and the burden of going forward with the evidence shifts to respondent. Dellacroce v. Commissioner, 83 T.C. 269, 280, 287 (1984).

Deciding whether the statutory notice of deficiency is arbitrary requires that we look behind the statutory notice to examine the evidence used in making the determination, something this Court, as a general rule, is reluctant to do. Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324, 327 (1974). However, in circumstances where the respondent introduced no substantive evidence but rested only upon the presumption of correctness in cases involving unreported illegal income, we have overcome our reluctance, at the urging of petitioner, and have looked behind the notice of deficiency. Shriver v. Commissioner, 85 T.C. 1, 3 (1985); Dellacroce v. Commissioner, supra.

In the instant case, however, petitioner failed to raise his challenge as to the validity of the statutory notice in his pleadings. Raising the issue for the first time on brief denied respondent the opportunity to put on evidence at trial supporting the validity of the statutory notice and constitutes unfair surprise and prejudice. Cf. Seligman v. Commissioner, 84 T.C. 191, 197-199 (1985). Because the issue was not raised in a timely fashion, it is deemed conceded. Rule 34(b)(4), Tax Court Rules of Practice and Procedure. Consequently, we will not look behind the statutory notice in the instant case, and petitioner bears the burden of proving that the Commissioner's determination of deficiency is incorrect.

Having found that the notice of deficiency was not arbitrarily issued, we must decide whether the Commissioner's determination was incorrect.

The Commissioner may use any reasonable means of reconstructing income. He is also given greater latitude in choosing which method of reconstruction to apply where the case involves an illegal enterprise in which the taxpayer has failed to file a return and has kept no records. Further, mathematical exactitude in the determination is not required, for, if it were, it "would be tantamount to holding that skillful concealment is an invincible barrier to proof." United States v. Johnson, 319 U.S. 503, 517-518 (1943).

The Commissioner used a variation of the expenditures method to determine that petitioner expended $64,820 on cocaine, hashish, and marijuana. The Commissioner determined that petitioner expended $741.60 for ordinary living expenses from January 1, 1981, until March 26, 1981, based upon Bureau of Labor statistics. The Commissioner also determined that petitioner had additional income in the amount of $14,060 based upon the amount of currency he had at the time of his arrest,[1] resulting in total income for the period from January 1 to March 26, 1981, of $79,621.60. The expenditures method is a permissible method to reconstruct the income of a taxpayer. Taglianetti v. United States, 398 F.2d 558, 562 (1st Cir. 1968), affd. 394 U.S. 316 (1969); Burgo v. Commissioner, 69 T.C. 729, 742 (1978).

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[1] The Commissioner's use of the $14,060 in cash as part of his calculation of unreported income indicates that he is using a combination of the net worth and expenditures methods. Because both methods are essentially the same, this will have no impact on the validity of the Commissioner's determination. See Taglianetti v. United States, 398 F.2d 558, 562 (1st Cir. 1968), affd. 394 U.S. 316 (1969).

Petitioner contends that the source of the currency and drugs found in his possession upon his arrest was not unreported income, but loans from friends and relatives. Petitioner testified that he had supported himself for several years by borrowing money without interest and without terms of repayment from several individuals. Petitioner's wife testified that her family lent petitioner and her a total of $9,500 over a period of years prior to 1981. Two cousins of petitioner, both automotive workers, testified that they had lent a total of $28,000 to petitioner over a period of several years.

Petitioner testified that his cousins and the other individuals who lent him money were aware that the loan proceeds were being used by petitioner to support his drug addiction, his gambling habit, and to purchase an automobile. However, petitioner, his wife, and his cousins failed to introduce any contemporaneous records of the alleged loans. Petitioner did not call any other witnesses regarding the loans. Simply stated, we find the testimony of petitioner, his wife, and his cousins to be incredible. Petitioner would have us believe that his only means of support during the period in issue was the alleged loans. His story is inconsonant with the lifestyle of a man supporting a serious drug addiction who was found to have in his possession substantial amounts of cash, jewelry, and drugs, as well as an automobile. More importantly, his story is much less likely true in the face of his admission that he sold cocaine in the past and his conviction for possession of controlled substance with the intent to sell. We are satisfied that the Commissioner correctly determined that petitioner earned the income set forth in the statutory notice.

As an alternative argument, petitioner contends that only a portion of the cocaine in his possession belonged to him and that, therefore, the determination of the Commissioner that the cocaine represented $64,000 of unreported income was erroneous. Petitioner argued that he was merely delivering the cocaine on behalf of himself and his co-venturers. His testimony on this subject was confusing and vague. We believe that if this contention were true, petitioner could have provided a much clearer picture of the specifics of the transaction.

Although respondent did not introduce any evidence at trial to refute the testimony of petitioner or petitioner's witnesses, we are not bound to accept the uncontradicted testimony of a taxpayer or other interested parties if it is improbable, unreasonable, or questionable. MacGuire v. Commissioner, 450 F.2d 1239, 1244 (5th Cir. 1971). We reject petitioner's testimony as being improbable, unreasonable, and questionable. Likewise, we reject the testimony of petitioner's wife and cousins, particularly in light of the potential for bias in their testimony. Because petitioner has failed to meet his burden of proof, we find that the Commissioner correctly determined that petitioner had unreported income of $79,621.60 for the taxable year 1981.

Decision will be entered for the respondent.

COMPLETED 14

Ju 11.7/2: 1986-62

MF112

T. C. Memo. 1986-62

UNITED STATES TAX COURT

RALPH AND GERTRUDE TOBJY, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17484-81. Filed February 11, 1986.

Ralph Tobjy, pro se.

Peter Devlin, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, Judge: Respondent determined a deficiency of $8,100.00 in petitioners' joint 1978 Federal income tax. Respondent made the following adjustments in his statutory notice of deficiency:

ORIGINAL

Residential Rental Expenses	$ 34,072.00
Exemption	Disallowance of exemption claimed for Roscio Menoscal
Interest Expense	1,000.00
Contributions	1,290.00
Medical and Dental Expenses subject to limitation as determined	911.00
Standard - Itemized Deductions	(226.00)
Total Adjustments	$ 37,047.00

This case was tried and submitted to the Court at New York, New York on April 24, 1984. The Court directed the parties to file briefs on or before June 25, 1984. Subsequently, the Court extended such due date until July 25, 1984. Respondent timely filed a brief. However, petitioners failed to file a brief within the extended due date of July 25, 1984. Consequently, on October 4, 1984, this Court ordered that no further briefs be accepted in this case. Because this case concerns substantiation of asserted deductions and a dependency exemption, we note at the outset that respondent's determinations are presumptively correct and petitioners bear the burden of proof. Welch v. Helvering, 290 U.S. 111, 115, (1933); Rule 142(a).[1] For convenience our Findings of Facts and Opinion are merged and are segregated by issue. The stipulation of facts and attached exhibits are incorporated herein by this reference.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

Residential Rental Property

Petitioner Ralph Tobjy purchased the following properties as newly constructed residential property:

Description of property	Year acquired	Purchase Price
Two-family residence at 750 Schenck Avenue Brooklyn, New York ("Schenck Avenue")	1962	$25,000.00
Three-family residence at 41-32 Little Neck Parkway, Little Neck, New York ("Little Neck Parkway")	1971	$80,000.00
One-family condominium apartment at Girasol Condominium, Isla Verde Road, Isla Verde, Puerto Rico ("Isla Verde Road")	1973	$30,000.00
One-family condominium residence at 274 Artist Lake Drive, Middle Island, New York ("Artist Lake Drive")	1975	$30,000.00

On their joint 1978 Federal income tax return, petitioners claimed deductions for depreciation and other expenses as follows:

Property	Depreciation	Other Expenses
Schenck Avenue	$ 1,250.00	$ 3,700.00
Little Neck Parkway	5,333.00	8,126.00
Isla Verde Road	2,285.00	5,645.00
Artist Lake Drive	2,571.00	5,162.00
Total	$11,439.00	$22,633.00

Petitioners assigned a twenty-year useful life to each residential property for depreciation purposes. Petitioner Ralph Tobjy testified that the twenty-year useful life was determined based upon his life expectancy. In depreciating the subject rental properties, petitioners included the value of land within the unadjusted depreciable basis. During the year in issue, petitioners occupied one of the two six-room apartments at the Little Neck Parkway property as a personal residence. On their 1978 joint Federal income tax return, petitioners did not allocate the portion of depreciation and other expenses associated with the Little Neck Parkway property which were attributable to personal use but, rather, deducted all such expenses.

For prior taxable years, petitioners' depreciation deductions on the subject rental properties for which petitioners received a tax benefit totalled as follows:

Property	Pre-1978 Depreciation
Schenck Avenue	$19,625.00
Little Neck Parkway	29,071.00
Isla Verde Road	7,617.00
Artist Lake Drive	6,160.00

Petitioners have used the straight-line method and the sum of the years digits method to compute depreciation on the subject residential properties. Respondent does not take exception to the use of such methods. At issue is petitioners' depreciable basis in each property and the useful life of each property.

Respondent has determined an allocation of basis and the economic useful life of the subject properties at the time of purchase as follows:

Property	Land	Building	Total	Economic Useful Life
Schenck Avenue	$3,750.00	$21,250.00	$25,000.00	40 years
Little Neck Parkway	7,000.00	73,000.00	80,000.00	45 years
Artist Lake Drive	3,000.00	27,000.00	30,000.00	40 years
Isla Verde Road	4,500.00	25,500.00	30,000.00	40 years

These determinations reflect the opinion of respondent's expert witness Leonard S. Rodwin ("Rodwin"). Rodwin has been an employee of the Internal Revenue Service ("IRS") for 17 years. Rodwin was hired by the IRS during 1966 as a real estate appraiser in the Manhattan District. Since 1969, he has been assigned to the National Office in Washington, D.C., where his responsibilities concern the determination of the fair market value of real estate, the fair rental value of real estate, the allocation of lump sum purchases, and the economic useful life of real estate. Rodwin viewed the Schenck Avenue, the Little Neck Parkway, and the Artist Lake Drive properties and determined the allocation of basis and economic useful life of such properties within his valuation report. At trial, Rodwin testified as to his opinion concerning the Isla Verde Road property in Puerto Rico which he did not view.

Petitioners did not introduce any objective evidence of value concerning the allocation of basis or economic useful life. Therefore, we find that petitioners have failed to meet their burden of proof. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a). Rodwin was a credible witness. We agree with respondent's determination of the allocation of basis between depreciable property and nondepreciable land as well as respondent's determination of the economic useful life of each subject property. Petitioners' assertion that useful life be determined by reference to the owner's life expectancy is specious and without merit as useful life may not be determined by reference to the owner's life expectancy. Coussement v. Commissioner, 391 F.2d 227 (6th Cir. 1968), affg. a Memorandum Opinion of this Court. Furthermore, the facts are inconsistent with petitioner Ralph Tobjy's testimony that useful life was determined by reference to his life expectancy as the residential properties were purchased during the years 1962, 1971, 1973 and 1975 and each was assigned a twenty-year useful life. We find that petitioners arbitrarily assigned a twenty- year useful life to each property and that such determination was not reasonable.[2]

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[2] Easter v. Commissioner, T.C. Memo. 1964-58, affd. per

(footnote continued)

On their joint 1978 Federal income tax return, petitioners claimed other expenses concerning the residential properties in the amount $22,633.00 which respondent disallowed in his statutory notice of deficiency. Subsequently petitioners substantiated the following expenses concerning the subject residential properties:

	Schenck Avenue	Little Neck Parkway	Isla Verde Road	Artist Lake Drive	Total
Real Estate Taxes	$ 755.75	$ 3,237.48	$ 321.09	$ 1,358.66	$5,672.98
Interest	-	3,460.47	1,543.35	2,083.85	7,087.67
Water and Sewer	124.69	210.00	-	-	334.69
Insurance	-	111.00	43.89	-	154.89
Maintenance	-	-	452.04	-	452.04
Heating	793.07	-	-	-	793.07
Total	$1,673.51	$7,018.95	$2,360.37	$3,442.51	$14,495.34

At trial, respondent conceded an additional expense of $248.28 for real estate taxes on the Schenck Avenue property. On brief, respondent further conceded an additional expense in the amount of $197.16 as repairs constituting ordinary and necessary

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(footnote continued from previous page)
curiam, 338 F.2d 968 (9th Cir. 1964), cert. denied 381 U.S. 912 (1965).

expenses.[3] Accordingly, other expenses in the amount of $14,940.78 have been either substantiated by petitioners or conceded by respondent.

During the year in issue, petitioners occupied one of the two six-room apartments at the Little Neck Parkway property. The Little Neck Parkway property consists of two six-room apartments plus one four-room apartment, for a total of 16 rooms. Respondent asserts that three-eighths of the depreciation expense and other expenses concerning the Little Neck Parkway property constitute nondeductible personal living expenses. Petitioners have introduced no evidence to refute respondent's allocation as to personal expenses concerning the Little Neck Parkway property. Therefore, petitioners have failed to satisfy their burden of proof. Welch v. Helvering, supra; Rule 142(a). We agree with respondent's assertion that the business use portion of the Little Neck Parkway property is limited to five-eighths of the determined depreciation amount and other expenses.[4]

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[3] Because the record is not clear as to the subject properties to which the repairs related, we allocate the $197.16 to properties other than the Little Neck Parkway property so as to avoid further allocation of such expense between business and personal use property relevant to the Little Neck Parkway property.

[4] Respondent concedes three-eighths of the real estate taxes and interest on the Little Neck Parkway property are otherwise deductible as itemized deductions on Form 1040, Schedule A.

In 1977, petitioners installed window guard rails at the Schenck Avenue property at a cost of $1,800.00. Petitioners assert that they are entitled to depreciate the window guard rails, however, they have introduced no evidence as to the economic useful life of such property. We therefore determine that petitioners have not met their burden of proof necessary to establish entitlement to depreciate such improvements. Welch v. Helvering, supra; Rule 142(a).

At trial, petitioners offered various cancelled checks concerning automobile insurance and related expenses as well as oral testimony regarding purported travel expenses incurred with regard to the rental properties. Petitioners maintained no records to support the travel expenses asserted. Petitioner Ralph Tobjy's testimony concerning the automobile insurance was inconsistent and equivocal. Petitioners also assert entitlement to depreciate a Volkswagon automobile purchased during 1976 at a cost of $4,384.50. In depreciating the automobile, petitioner Ralph Tobjy testified that he used the straight-line method and assigned a three-year useful life with no salvage value. Petitioner Ralph Tobjy further testified that the business use portion of the Volkswagon was 75 percent and that personal use was limited to 25 percent. Petitioners failed to substantiate their assertions by means of reliable objective evidence such as contemporaneous records. Additionally, petitioner Ralph Tobjy's testimony was inconsistent and not credible. We do not doubt that expenses attendant to the use of an automobile concerning the residential rental properties were incurred. As in Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), the inexactitude herein was of petitioners' own making by failing to maintain adequate records, and this must weigh heavily against them. However, petitioners have not given us any basis other than petitioner Ralph Tobjy's self-serving testimony upon which we may estimate reasonable allowances.[5] Therefore, we find that petitioners have not offered sufficient evidence to establish an entitlement to automobile depreciation or the attendant automobile expenses for travel and insurance.[6]

Petitioner Ralph Tobjy also testified at trial that petitioners were entitled to telephone expenses, postage expenses, and a home office deduction under section 280A. No evidence other than self-serving testimony consisting of estimated expenses was introduced to substantiate these claims. Therefore, petitioners have failed to satisfy their burden of proof as to these expenses. Welch v. Helvering, supra; Rule 142(a).

Interest Expense

Petitioners claimed an interest expense deduction of $1,000.00 on their joint 1978 tax return. Subsequently, petitioners substantiated interest expenses for the 1978 taxable year in the amount of $1,175.51. Petitioners substantiated an additional interest expense of $3,460.47 incurred with respect to the mortgage on the Little Neck Parkway property. We have previously determined that the business use portion of the Little Neck Parkway property was limited to a pro rata five-eighths of such property during 1978. Consequently, we have determined that petitioners were entitled to depreciation and other expenses relating to such property in an amount not in excess of a pro rata five-eighths allocation of such expenses. Petitioners are, however, entitled to deduct additional interest as an itemized deduction in the amount of $1,297.68 which represents a pro rata three-eighths of the mortgage interest expense incurred with respect to the personal use portion of the Little Neck Parkway property.[7] Petitioners, by aggregating the interest expense substantiated and the interest expense allocated to personal use property, are entitled to an itemized interest expense deduction in the amount of $2,473.19 for 1978.

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[5] Loos v. Commissioner, T.C. Memo. 1967-37.

[6] Roberts v. Commissioner, T.C. Memo. 1986-11; Smith v. Commissioner, T.C. Memo. 1982-546; Green v. Commissioner, T.C. Memo. 1982-485.

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[7] Little Neck Parkway property interest:

Personal allocation	$1,297.68
Business allocation	2,162.79
	$3,460.47

Charitable Contribution Deduction

Petitioners claimed a charitable contribution deduction of $1,290.00 on their joint 1978 Federal income tax return. Petitioners have substantiated that they donated the amount of $875.00 during 1978 to various qualified charitable donees under section 170. At issue is whether petitioners are entitled to deduct the amount of $400.00 that they donated in 1978 to an organization titled FANN.[8] FANN is a private orphanage in Ecuador which is not affiliated with any organization in the United States or with any church. FANN is privately financed by a wealthy Ecuadoran businessman. We determine that FANN does not qualify as charitable donee under section 170(c)(2)(A) since it was not created or organized in the United States, a state or territory, the District of Columbia or a possession of the United States. ErSelcuk v. Commissioner, 30 T.C. 962 (1958).[9] Consequently, petitioners are not entitled to deduct as a charitable contribution in 1978 the $400.00 they paid to FANN.

Exemption

Petitioners claimed a dependency exemption for Roscio Menoscal ("Roscio"). Roscio is a citizen of Ecuador and is not related to petitioners. Roscio resided with petitioners during

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[8] Petitioners claimed a charitable contribution deduction in the amount of $1,290.00 on their 1978 joint tax return. Petitioners substantiated the amount of $875.00 and respondent has disallowed the amount of $400.00 paid to FANN. Therefore, the amount of $15 is unreconciled.

[9] Herter v. Commissioner, T.C. Memo. 1961-19.

1978. Petitioner Ralph Tobjy was unable at trial to recall the approximate duration of Roscio's residence with petitioners. Roscio entered the United States with a student visa although she was not a recipient of a scholarship or any government assistance. Roscio desired to study English in the United States. Petitioners accommodated Roscio with necessities and paid certain tuition expenses on her behalf at Queens College and the English Language Institute to enable Roscio to study language.

Section 152 provides a dependency exemption where certain criteria are established. Petitioners have failed to satisfy their burden of proof to establish entitlement to a dependency exemption under section 152. Section 152(b)(3) provides that an individual who is not a citizen, resident, or national of the United States cannot qualify as a dependent unless such individual is a resident of a foreign country contiguous to the United States. Roscio was a nonresident alien as defined in section 7701 and was a citizen of Ecuador, a noncontiguous country. Therefore, petitioners fail to satisfy the section 152(b)(3) requirement. Barr v. Commissioner, 51 T.C. 693, (1969).[10] Furthermore, petitioners failed to introduce sufficient evidence to determine whether petitioners furnished over one-half of Roscio's support. Sec. 152(a). Therefore, petitioners are not entitled to claim a dependency exemption for Roscio.

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[10] Hsu v. Commissioner, T.C. Memo. 1982-47.

To reflect the foregoing,

Decision will be entered under Rule 155.

COMPLETED 8

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T. C. Memo. 1986-63

UNITED STATES TAX COURT

ESTATE OF ROBERT W. HASS, NELLIE S. HASS, EXECUTRIX,
Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 11967-82. Filed February 11, 1986.

William J. Crowell, Jr., for the petitioner.

A. Chris Zimmermann, for the respondent.

MEMORANDUM OPINION

WILLIAMS, Judge*: The Commissioner determined a deficiency of $31,664.31 in Federal estate tax. After concessions by the parties, the remaining issue before this Court is whether the purchase by decedent's wife of a policy

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* By order of the Chief Judge, this case was reassigned to Judge Williams for decision and opinion.

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insuring her husband's life that was paid for out of community property funds constitutes a transfer by decedent within the meaning of section 2035.[1]

The parties have submitted this case with the facts fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure. Nellie S. Hass, Executrix of the Estate of Robert W. Hass, the petitioner in this case, was a legal resident of Carson City, Nevada at the time of the filing of this petition.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect at the time of decedent's death. Section 2035 provided in pertinent part:

SEC. 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

(a) Inclusion of Gifts Made by Decedent.--Except as provided in subsection (b), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(b) Exceptions.--Subsection (a) shall not apply--

(1) to any bona fide sale for an adequate and full consideration in money or money's worth, and

(2) to any gift to a donee made during a calendar year if the decedent was not required by section 6019 to file any gift tax return for such year with respect to gifts to such donee.

Paragraph (2) shall not apply to any transfer with respect to a life insurance policy.

Nellie is the surviving spouse of Robert W. Hass, who died at the age of 53 on July 6, 1978. The decedent had four children who survived him. The Federal tax return for the estate of the decedent was timely filed.

The decedent and Nellie Hass entered into an Agreement and Declaration of Manner of Owning Property on November 15, 1969. The Agreement provides that:

> The purpose of this agreement is that the undersigned hereby declare that all of our property is community property * * * for the reason that in truth and in fact all of our property was acquired by us with community funds and is in truth and fact community property and each of us owns one-half of said community property in his or her individual right without any disturbance of the title thereto.

This Agreement had not been rescinded at the time of decedent's death, and was referred to and affirmed in the separate wills of both the decedent and Nellie Hass.

At the time of his death there were three life insurance policies on the life of the decedent in addition to the policy in dispute in this case. The three policies were all community property, and their proceeds totalled $70,705.74.

The policy in dispute in this case was a level 5-year term convertible and renewable life insurance policy issued by United Benefit Life Insurance Company (the United policy) in the amount of $100,000. The application for the United policy was signed by the decedent as insured and by Nellie Hass as applicant. The United policy was issued on May 3, 1978. A Supplementary Provision attached to the United policy identifies Nellie Hass as having all ownership rights and interest in the policy. The provision states:

> It is understood and agreed by the Insured that the sole Owner of this policy is Nellie S. Hass, Wife of the Insured. Said Owner shall have all right and title to the insurance applied for as her separate property and may exercise every incident of ownership without the consent of the other person.

Nellie Hass was both the owner and the primary beneficiary of the policy. The children of the decedent were named as secondary beneficiaries.

The first annual premium of $1,444.00 was paid by three separate checks, each drawn on the account of Bonanza Realty. This account was the community property of the decedent and Nellie Hass on which each was authorized to draw. The first such check was dated March 27, 1978 in the amount of $266.00, and was signed by the decedent. The two remaining checks were both signed by Nellie Hass and dated May 9, 1978, in the amounts of $1,105.00 and $73.00, respectively.[2]

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[2] Though the Stipulation of Facts states this last check to be for the amount of $76.00, it is clear that this figure is a typographical error. The evidence, Exhibit 11-K, is a check drawn on the account of Bonanza Realty dated May 9, 1978 and signed by Nellie S. Hass for the amount of $73.00. The sum of the checks as recited above equals $1,444.00, the amount of the annual premium.

The decedent died within three months of the issuance of the United policy, and following his death Nellie Hass received the proceeds of the United policy in the amount of $101,772.39. Of this amount, $100,000.00 was for life insurance, $1,083.00 was unused premium, and $689.39 was interest. The respondent seeks to include one-half of this sum, or $50,886.00, in the estate of the deceased.[3]

In this case, the United policy is the separate property of Nellie. Kern v. United States, 491 F. 2d 436 (9th Cir. 1974). The Supplementary Provision of the insurance contract stipulates that Nellie Hass is the sole owner of the policy with "all right and title to the insurance applied for as her separate property * * *." In signing this provision, the decedent established the United policy as the separate property of his wife under Nevada law. Rogger v. Rogger, 96 Nev. 687, 615 P. 2d 250 (1980); Petition of Fuller, 63 Nev. 26, 159 P. 2d 579 (1945).

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[3] The respondent's deficiency notice shows an increase of only $15,532.00 to the insurance schedule of the estate tax return, rather than $50,886.00. This reduction is to compensate for an error in the original estate tax return which included the entire proceeds of the three life insurance policies in the decedent's gross estate. Since the policies were community property only one-half of the proceeds should have been included in the estate. Thus, only $35,353.00 should have been included in the insurance schedule, rather than $70,706.00. After accounting for this error, respondent calculates the remaining adjustment to be $15,532.00. In fact, the remaining adjustment should be $15,188.50 because the interest is not includible in the gross estate for Federal estate tax purposes.

Respondent argues that though the United policy may be the separate property of Nellie Hass, the policy was created by use of community funds, which for Federal estate tax purposes should be viewed as effecting a transfer of the policy by the decedent. Since the transfer occurred within three years of his death, respondent argues that section 2035 requires the value of the interest transferred to be included in the decedent's gross estate.

Petitioner contends that Nellie's use of the community funds to pay the premium was a lawful exercise under Nevada law within her own rights over the account. Consequently, petitioner argues there was no transfer from decedent for purposes of section 2035.

While Nellie's use of community funds to pay the premium was indisputably lawful, that point misses the mark. Nellie purchased separate property with community funds. The translation of community property into separate property involves a transfer by one spouse of his interest in those community funds to the other spouse. In this case, the decedent transferred his interest in the community funds to Nellie when the funds were used to pay the premium. Nellie's legal ability to use community funds to purchase separate property does not diminish the nature or the amount of the transfer.[4]

Furthermore, for Federal estate tax purposes, a husband's transfer of his funds to his wife for the purpose of purchasing life insurance on his life has been held to constitute a transfer of the policy itself. In First National Bank of Oregon v. United States, 488 F. 2d 575 (9th Cir. 1973), the decedent's spouse was the owner and beneficiary of two 20-year term life insurance policies, but all the premiums were paid within three years of decedent's death with funds of the decedent. The taxpayer argued that a transfer had not taken place since the decedent had never owned the policies. The court ruled that only a formal distinction existed between a situation in which the decedent purchases and then transfers the policies to his spouse, and one where the spouse purchases the policies with funds provided by the decedent. 488 F. 2d at 577. The court held that the proceeds of the policies were includible in the estate because payment of the premiums with decedent's funds constituted a transfer of the policies within the meaning of section 2035.

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[4] Whether Nellie or her husband signed the check drawing on the community account to pay the premium is immaterial. Both had full signatory power over the account. The decedent had fully stated his desire and intent that the United policy be owned separately by Nellie, and it was separate property. When community funds were used to purchase that separate property, those funds were transferred to Nellie whether decedent or Nellie signed the check.

In Estate of Kurihara v. Commissioner, 82 T.C. 51 (1984), the decedent established an irrevocable trust for the benefit of his spouse and two children and transferred funds to the trust which were used to purchase a life insurance policy on the life of the decedent. The trustees of the trust were named as the beneficiaries of the policy. The decedent died within three months of the issuance of the policy. In Kurihara, we articulated two questions that were determinative of whether section 2035 reached the proceeds of the policies insuring decedent's life: (1) did payment of a policy premium within the three-year period create the spouse's ownership rights in the policy; and, (2) did the decedent pay the premium? 82 T.C. at 60. Here, as in Kurihara, our answer to each question is affirmative, and we hold that the proceeds of the policies, in proportion to the decedent's interest in the community funds used to pay the initial premium, are includible in decedent's estate pursuant to section 2035. See also Detroit Bank and Trust Company v. United States, 467 F. 2d 964 (6th Cir. 1972), cert. denied 410 U.S. 929 (1973).

To reflect the exclusion of the interest income on the policy proceeds from the estate,

Decision will be
entered under Rule 155.

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T. C. Memo. 1986-64

UNITED STATES TAX COURT

FREDERICK I. UNGER AND JACQUELINE M. UNGER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9098-83. Filed February 11, 1986.

Sherin V. Reynolds, for the petitioners.

Richard G. Convicer, and Powell W. Holly, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, Judge: Respondent determined a deficiency in petitioners' Federal income tax in the amount of $672.31 for the taxable year 1979. After concessions, the issues remaining for

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decision are: 1) whether petitioners are entitled to deduct the cost of meals as employee business expenses under section 162;[1] and 2) whether petitioners are entitled to deduct the cost of automobile air conditioning in the amount of $650 as a medical expense deduction under section 213.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioners Frederick I. Unger and Jacqueline M. Unger, husband and wife, resided in Danbury, Connecticut, at the time their petition herein was filed.

Employee Business Expenses

During the taxable year 1979, Frederick Unger (hereinafter referred to as petitioner in the singular) was employed as a truck driver for the McLean Trucking Company. Petitioner reported for work at the truck terminal in Montgomery, New York, approximately one hour driving time or 55 miles from his personal residence in Danbury, Connecticut. Petitioner maintained daily logs indicating the time of arrival at Montgomery, New York, the amount of time spent driving, the times and cities cargo was delivered, the times and cities petitioner stopped for meals, coffee, and, occasionally, safety breaks, and the time of return to Montgomery, New York.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable year in question.

A typical trip would be a round trip between Montgomery, New York, and Woburn, Massachusetts. For example, on March 12, 1979, petitioner arrived at 10:30 p.m. at Montgomery, New York where he made a pre-trip inspection. At 12:30 a.m., March 13, 1979, petitioner stopped at Milldale, Connecticut, for a meal for one hour. He arrived at Woburn, Massachusetts, at 4:00 a.m. where petitioner was on duty, but not driving, until 5:15 a.m. Petitioner then drove to Milldale, Connecticut, where he stopped for a meal at 7:45 a.m. At 8:45 a.m., petitioner commenced driving back to Montgomery, New York, where he arrived at 10:30 a.m. The trip's duration was 12 hours.

On January 27, 1979, on another round trip between Montgomery, New York, and Woburn, Massachusetts, petitioner left the terminal in Montgomery, New York, at 3:00 a.m. At 5:15 a.m. he stopped in Milldale, Connecticut, for a meal for 1-1/4 hours. Petitioner then drove until 9:00 a.m. when he arrived at Woburn, Massachusetts and took a one hour safety break. Petitioner then commenced his return trip back and stopped at 11:15 a.m. for a second meal. He continued driving until 3:15 p.m. when he arrived at Montgomery, New York. The trip's duration was 12-1/4 hours. Petitioner also made trips to other cities in New England, such as Pawtucket, Rhode Island, and Shrewsbury, Connecticut. Petitioner returned to his home in Danbury, Connecticut after each trip where he would sleep. During the seven month period in question, petitioner made 126 turnaround trips. The trips averaged approximately 12-14 hours in length.

Petitioner made safety breaks during only 24 of those trips. Such safety breaks consisted of petitioner resting or sleeping at the wheel of his truck. Petitioner was only allowed to work a 70-hour week and he would take the breaks in order not to be over the 70-hour limit. The dates and duration of the safety breaks are as follows:

Date	Duration
January 18	2.5
January 24	1.0
January 25	2.0
January 27	1.0
February 1	1.75
February 24	2.0
March 6	2.0
March 9	.75
March 19	3.5
March 28	1.25
April 1	1.5
April 21	2.25
April 29	2.0: 2.0
May 8	1.25
May 10	2.0
May 12	2.25
May 21	2.0
May 25	2.0
May 29	1.5
May 31	1.5
June 20	1.0: 1.75
June 29	2.0
July 14	2.0
July 19	1.75

The daily logs contain no entries as to the amounts petitioner spent for meals and coffee. Petitioner did not retain receipts for such expenditures. Petitioners used $12 per diem figure to claim meal expenses in the amount of $1,800.

Medical Expense Deduction

Because of petitioner's allergies and asthma, petitioner's physician recommended that petitioner remain in an air conditioned environment. When petitioner purchased a new 1979 Mazda, he had air conditioning installed at a cost of $650. Petitioners claimed the cost of the automobile air conditioning as a medical expense on their 1979 return. Respondent disallowed this expense on the grounds that the cost did not exceed the increase in the fair market value of the car in which it was installed.

OPINION

1. Employee Business Expenses.

Section 162(a)(2) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including "traveling expenses (including amounts expended for meals and lodging * * *) while away from home in the pursuit of a trade or business * * *."

Respondent contends that the meal expenses incurred by petitioner are not deductible under section 162(a) because they were not incurred by petitioner while traveling away from home. Petitioners argue that because petitioner was away from home overnight, petitioner satisfies the sleep or rest rule enunciated in United States v. Correll, 389 U.S. 299 (1967).

In Correll, the Supreme Court approved respondent's application of the rule that travel "away from home" excludes all trips requiring neither sleep nor rest regardless of how many miles a given trip may have covered, or how many hours it may have taken. Although recognizing that the rule must make some arbitrary distinctions, the Court believed that the rule achieved "substantial fairness" in that it treats similarly all one-day travelers, be they intra-city commuters or traveling salesmen. Intrepreting the language of the statute, the Court stated:

> the statute speaks of "meals and lodging" as a unit, suggesting--at least arguably--that Congress contemplated a deduction for the cost of meals only where the travel in question involves lodging as well. Ordinarily, at least, only the taxpayer who finds it necessary to stop for sleep or rest incurs significantly higher living expenses as a direct result of his business travel, and Congress might well have thought that only taxpayers in that category should be permitted to deduct their living expenses while on the road. * * * [389 U.S. at 304-305. Footnotes omitted.]

In the instant case, during the vast majority of the trips, petitioner did not stop for a period of sleep or rest. Petitioners nevertheless contend that petitioner satisfied the sleep or rest rule because he was literally away from home overnight in that he usually began work during the night time one day and finished during the daylight hours of another. The fact that petitioner's regular working hours occur at night, or that they cover a portion of two days, however, is not material. Herrin v. Commissioner, 28 T.C. 1303, 1305 (1957). The important fact is that it was not necessary for petitioner to sleep or rest, nor did he during his trip.

As to those trips where petitioner did take safety breaks, petitioners have failed to show that such breaks were required for substantial sleep or rest. Such breaks were not taken on a regular basis. Petitioners have not shown that those trips where petitioner did take safety breaks involved greater hours or further destinations than those where petitioner did take such breaks. Petitioners rely on the case of Anderson v. Commissioner, 18 T.C. 649 (1952). However, in Anderson, the taxpayer, a railroad express employee, was released for a period of rest during each of his round trip runs which lasted between 16 to 18 hours. The Court specifically found that such rest periods were necessary.

Furthermore, the rest period required by the sleep or rest rule contemplates "a stop of sufficient duration that it would normally be related to a significant increase in expenses." Barry v. Commissioner, 435 F.2d 1290, 1291 (1st Cir. 1970), affg. 54 T.C. 1210 (1970). Petitioners have not shown that the type of rest period which petitioner took was the type which involves special arrangement or special expense. Petitioner's resting at the wheel does not constitute more than a mere pause from the daily work routine.[2] Thus, petitioner does not satisfy the sleep or rest rule and was not traveling away from home when his meal expenses were incurred.

Additionally, even if petitioners had established that these expenses were incurred while away from home, petitioners have failed to meet the substantiation requirements of section 274(d).

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[2] See Stevens v. Commissioner, T.C. Memo. 1985-16; Siragusa v. Commissioner, T.C. Memo. 1980-68, affd. without published opinion 659 F.2d 1062 (2d Cir. 1981).

While the logs reveal the times and places of the meals, they do not show any amounts incurred for the meals.[3] Petitioners failed to produce any evidence which would prove such amounts. Therefore, respondent's determination on this issue is sustained.

2. Medical Expense Deduction.

Respondent does not dispute that the automobile air conditioning was for medical purposes.[4] Respondent contends, rather, that petitioners have failed to show that the expense exceeded the increase in value of the automobile.

Petitioners contend that because the air conditioning is easily installed and removed from the car, it is the type of capital expenditure which is deductible as a medical expense pursuant to section 1.213-1(e)(1)(iii), Income Tax Regs., which provides:

> a capital expenditure which is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as an expenditure for medical care, shall be deductible; for example, an expenditure for eye glasses, a seeing eye dog, artificial teeth and limbs, a wheel chair, crutches, an inclinator or an air conditioner which is detachable from the property and purchased only for the use of a sick person, etc. * * * [Emphasis added.]

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[3] This Court has consistently held that such log books do not fulfill substantiation requirements of section 274(d). Hollesen v. Commissioner, T.C. Memo. 1979-269; Reynolds v. Commissioner, T.C. Memo. 1979-190; Hamilton v. Commissioner, T.C. Memo. 1979-186; Henson v. Commissioner, T.C. Memo. 1979-110.

[4] Although respondent raised this issue for the first time at trial, respondent abandoned it on brief and therefore appears to have conceded the issue.

Unfortunately, petitioner has failed to present any evidence in the record as to whether the air conditioning is detachable from the car. A capital expenditure which is a permanent improvement to the property is deductible to the extent that it is in excess of the increase in value to the property. Gerard v. Commissioner, 37 T.C. 826, 829-830 (1962). Respondent disallowed the deduction in the instant case on the basis that the cost of the air conditioning did not exceed the increase in value to the car. Petitioners have the burden of proof on this issue. Rule 142(a), Tax Court Rules of Practice and Procedure. Petitioners did not present any evidence with respect to the value of the car. Therefore, respondent must be sustained on this issue.

Because of concessions,

Decision will be entered
under Rule 155.

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T. C. Memo. 1986-65

UNITED STATES TAX COURT

JAMES J. FLOOD AND DONNA A. FLOOD, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17066-82. Filed February 11, 1986.

James J. Flood, pro se.

Irene Scott Carroll, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: With respect to petitioners' Federal income tax for 1978, respondent determined a deficiency of $13,036, and an addition to tax of $900.95 under section 6651(a)(1).[1] After concessions, the issues for consideration are (1) whether certain

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended and in effect for the taxable year at issue.

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stock issued to petitioner[2] qualifies as section 1244 stock, (2) whether this stock became worthless in 1978 or 1977, and (3) whether petitioners had reasonable cause for failing to timely file their 1978 Federal income tax return.

FINDINGS OF FACT

Some of the facts have been stipulated by means of a stipulation of facts, as amended, along with attached exhibits, all of which are incorporated herein by this reference.

Petitioners are husband and wife. During the taxable year at issue, petitioners resided in La Jolla, California. Petitioners filed their 1978 U.S. Individual Income Tax Return with the Internal Revenue Service Center in Fresno, California. Although their return was due April 16, 1979, petitioner did not mail it until April 23, 1979. Petitioner lacked reasonable cause for filing late.

In 1974 petitioner started a business, Lil David Gawfe Tools, Inc. (Lil David). Lil David incorporated in California on May 20, 1974, for the primary purpose of manufacturing and selling golf clubs, shafts, heads, equipment, tools and accessories. Lil David was authorized to issue only one class of stock, in the total number of 2,500,000 shares, with each share having a par value of one cent for an aggregate par value of $25,000. Irving Fields, Monica Wood and Lynne Colvig incorporated Lil David and were appointed as its first directors.

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[2] As used hereafter, "petitioner" refers to James J. Flood.

On June 17, 1974, the board of directors of Lil David held its first meeting. The minutes of this meeting reflect that at this time Fields, Wood and Colvig resigned and were succeeded as directors by petitioner, Bill Bailey and Robert Gould. The minutes further reflect that petitioner became chairman of the board and was president of Lil David. With respect to qualification of Lil David's stock under section 1244, the minutes state as follows:

> ADOPTION OF 1244 PLAN
>
> Mr. Fields discussed the requirements necessary for being a small business under Section 1244 of the Internal Revenue Code. The Board therefore is adopting a written plan to qualify the stock under Section 1244 of this code.
>
> RESOLVED, that:
>
> 1. Only one class of stock be authorized which is common stock. This stock is non-convertable [sic] into any other securities of the corporation.
>
> 2. The Corporation qualifies as a small business corporation and only common stock will be outstanding.
>
> 3. The stock will be issued in exchange for money or property other than stock or security.
>
> 4. The amounts of money or property to be paid for the stock offered as a contribution to capital and as paid in surplus shall not exceed $500,000.
>
> 5. The amounts to be paid for the stock offered under this written plan plus the equity Capital of the Corporation as of the date of the adoption of the plan shall not exceed $1,000,000.

A typed, unsigned writing on the stationery of Fields, Fehn & Feinstein, Attorneys at Law, bearing the date June 17, 1974, provides as follows:

Section 1244 I.R.C. Requirements

1. Written plan.
2. Common stock.
3. Domestic corporation.
4. Two year maximum stock issuance period, after date plan adopted.
5. "Small business corporation" at time plan adopted
    a. $500,000.00 amount to be paid for stock limitation
    b. $1,000,000.00 equity capital limitation
6. No prior offering outstanding
7. Stock issued for dollars and/or property
8. No new offering to issue stock after adoption of plan and before section 1244 stock used.

On July 1, 1974, Lil David filed an application to issue stock with the California Department of Corporations. On July 11, 1974, Lil David received its first permit to issue stock. On July 16, 1974, petitioner was issued 90,000 shares for $900.

On October 6, 1975, Lil David applied to the Department of Corporations for a permit to issue 130,500 shares of common stock at $6 per share, for a proposed maximum aggregate offering price of $783,000. At the time of the application, Lil David had outstanding 142,000 shares of common stock. The application and the minutes of a board of directors meeting held on October 27, 1975, reflect that the application was filed to enable Lil David to offer the following numbers of shares to the following individuals and entity: 36,000 shares of stock to petitioner and Scottish Golf Company, his affiliate, in cancellation of $216,000 of indebtedness due petitioner and his affiliate; 94,214 shares[3] on a preemptive basis to stockholders of record; and, after the date of the preemptive offer, any number of shares to George Swerdlow and Frank Vivacquia, provided the total number of shares sold to shareholders and the two persons mentioned did not exceed 94,214 shares. A permit was granted on October 14, 1975. The board approved the offering at its October 27, 1975, meeting. On December 1, 1975, petitioner received 22,443 shares of Lil David stock as part of this offering, in exchange for the cancellation of $134,658 of debt owed him for loans made to the corporation between May 1974 and October 1975.

At the time they obtained the new permit to issue stock, the directors of Lil David did not adopt a new plan under section 1244. Petitioner believed that Lil David already had a valid section 1244 plan that would cover the new stock issuance made pursuant to the October 14, 1975, California Department of Corporations permit.

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[3] Lil David requested authority to offer 94,500 shares (exclusive of the shares offered petitioner and Scottish Golf Company) in order to round out all fractional shares to a whole number.

Lil David ultimately received less than $500,000 from the sale of all offerings of stock.

Lil David eventually suffered severe financial reverses and on or before October 19, 1977, petitioner was aware that the corporation might fold. By letter of that date, petitioner advised shareholders of Lil David's circumstances. The letter related that in 1975 Lil David had refused delivery of "Slinger" golf heads from a casting company called Fansteel. It stated that "Fansteel, Inc., since last January, has offered Slingers * * * at, in some cases, 70% below our price. For the fiscal year ended March 31, we were profitable and would have remained so if Fansteel had not literally put Lil' David out of business." The letter further related that in December 1976 Chemwell Industries had bought approximately 25 percent of Lil David for $125,000, and had lent Lil David $45,000 to purchase new materials. Petitioner further stated:

> This loan was secured by all my personal stock and all unpledged assets of the Company. At the time there was no doubt that Seibu [a Japanese department store chain] would continue business in large volume.
>
> * * *
>
> However, because of Fansteel's unfair competition sales fell to almost zero and Chemwell halted the proposed merger. It was a devastating blow.

The letter noted that Chemwell had attached the assets and that Lil David did not have the money to bring suit against Fansteel. Petitioner concluded the letter with the following sentence: "Unless we realize victory in a suit against Fansteel, or buy our assets back from Chemwell, the stock is worthless." Lil David subsequently neither bought the assets back nor brought an unfair competition action against Fansteel.

From the time he wrote the letter to February 1978, petitioner contacted lenders and other companies in an attempt to borrow enough money to buy back his pledged stock, and to bring Lil David back to a profitable position. Although these efforts ultimately were unsuccessful, Lil David did engage in a certain amount of business activity through part of 1978. Lil David continued to ship to Seibu department stores. In December 1977, the Professional Golfers Association of Thailand wrote to Lil David about its golf clubs, and in January 1978 Lil David shipped some clubs to the executive director of the association. In January 1978, Lil David sent a Texas company a contract to act as an independent representative for the sale of certain Lil David products to department store outlets. Petitioner, who by that time had been replaced as president of Lil David by the president of Chemwell Industries, was hopeful that the Texas company would buy Lil David's entire inventory of golf clubs. Such a sale, he believed, would make Lil David profitable again and would enable him somehow to buy back his stock. The Texas company, however, neither signed the proffered contract nor bought the inventory. In January 1978, a Canadian company wrote Lil David about acting as its distributor in Western Canada.

Petitioner personally did not give up hope on his Lil David stock until sometime between June and August of 1978. On their Form 1040 for 1978, petitioners claimed a capital loss carryover from 1977, which they attributed to the total worthlessness in the latter year of $134,658 in Lil David stock. They reported no capital gains. Based on the capital loss carryover, petitioners claimed a $3,000 capital loss on their 1978 tax return.[4]

By notice of deficiency, respondent disallowed the $3,000 capital loss claimed by petitioners, and additionally proposed other adjustments and a 5-percent addition to tax pursuant to section 6651(a). Petitioners subsequently filed a petition with this Court, and then an "Amendment to Petition." In this latter document petitioners asserted that they suffered a $134,658 ordinary stock loss under section 1244 in "1977/1978" on account of the worthlessness of their stock in Lil David.

OPINION

Issuance of Section 1244 Stock

As a general rule, losses incurred when capital stock becomes worthless are capital losses and are deductible only to the extent of a taxpayer's capital gains plus $3,000 of his ordinary income. See secs. 165(g)(1), 1211 and 1221. Section 1244 provides an exception to this rule for stock qualifying as "section 1244 stock." "Section 1244 stock" is common stock in a

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[4] Sec. 1211(b) limited the capital loss petitioners could claim to $3,000.

"small business corporation" that has "adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan." Sec. 1244(c)(1). To qualify as a "small business corporation," at the time of the adoption of the plan the aggregate amount which may be offered under the plan cannot exceed $500,000. See sec. 1244(c)(2)(A).

The parties disagree as to whether the 22,443 shares of Lil David stock issued to petitioner on December 1, 1975, were section 1244 stock.[5] Petitioner maintains that the requirements of section 1244 were met, while respondent asserts to the contrary. We agree with respondent.

Petitioners contend that the minutes of Lil David's first board meeting and the note entitled "Section 1244 I.R.C. Requirements" together meet the requirements for adoption of a section 1244 plan.[6] We need not decide whether petitioners are correct. Even if Lil David initially did adopt a valid section

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[5] The tax treatment of the 90,000 shares of Lil David stock issued to petitioner on July 16, 1974, is not in dispute.

[6] A sec. 1244 plan must be in writing and have a prescribed content. See sec. 1.1244(c)-1(c)(1), Income Tax Regs. (Current sec. 1.1244(c)-1(f)(1)(ii), Income Tax Regs., is substantially similar.) The plan may be stated in one or more documents. Mogab v. Commissioner, 70 T.C. 208, 213 (1978); Hayden v. Commissioner, 52 T.C. 1112, 1124 (1969).

1244 plan, the stock issued to petitioner on December 1, 1975, would not qualify as section 1244 stock because of the size of the offering pursuant to which it was issued.

Section 1244(c)(2) restricts the aggregate amount of stock that may be offered under a section 1244 plan to $500,000 or less. The mere possibility that a corporation may issue stock in excess of the $500,000 limitation disqualifies stock as section 1244 stock. Spillers v. Commissioner, 407 F.2d 530, 533 (5th Cir. 1969), affg. a Memorandum Opinion of this Court. Although a corporation may change its section 1244 plan, it must continue to adhere to the $500,000 limitation. See sec. 1.1244(c)-1(h)(2), Income Tax Regs.[7]

By permit dated October 14, 1975, Lil David received authority to issue a total of 130,500 shares of common stock at a proposed maximum offering price of $783,000. On October 27, 1975, as reflected in its corporate minutes, Lil David's board met and approved the offering, although the offering exceeded the $500,000 limitation.

We recognize that petitioner at this time thought that Lil David was still in compliance with section 1244. However, evidence of an intention to obtain the benefits of section 1244 is not enough in and of itself. Mogab v. Commissioner, 70 T.C. 208, 213 (1978). Strict compliance with the requirements of section 1244 and the regulations promulgated thereunder is necessary in order to obtain these benefits. Mogab v. Commissioner, supra at 212. Petitioner was persuasive and effective in his presentation, but the $134,658 of stock issued to him was part of an offering prohibited under section 1244 and, accordingly, we hold that petitioners are not entitled to claim an ordinary loss on its worthlessness.

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[7] Current sec. 1.1244(c)-1(f)(3)(ii), Income Tax Regs., is substantially similar.

Year of Stock Loss

Section 165(a) allows a deduction for losses sustained during the taxable year. Section 1.165-1(d)(1), Income Tax Regs., provides when the deduction may be taken:

> A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. * * *

Where stock which is a capital asset becomes worthless, a capital loss deduction is allowable under section 165(g).

The question of whether stock becomes worthless during a particular year is one of fact. Lincoln v. Commissioner, 24 T.C. 669, 694 (1955), affd. 242 F.2d 748 (6th Cir. 1957); Marsh v. Commissioner, 38 B.T.A. 878, 902 (1938). More than the taxpayer's subjective belief is required to establish that a stock became worthless during a particular year. Boehm v. Commissioner, 326 U.S. 287, 293 (1945); Aagaard v. Commissioner, 56 T.C. 191, 209 (1971); Hoover v. Commissioner, 32 T.C. 618, 630

(1959). The taxpayer must show that the stock had value at the beginning of the year and lost that value during the year. Hoover v. Commissioner, supra at 630.

Petitioners argue that Lil David's stock became worthless in 1978.[8] Respondent maintains that the stock became worthless in 1977.[9] We agree with respondent.[10]

The evidence presented shows that Lil David continued to operate through the early part of 1978, and that petitioner did not give up on the corporation until the summer of that year. Nothing in the record suggests, however, that Lil David had any significant volume of sales or business activity during 1978.

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[8] In certain circumstances, secs. 1311-1314 lift the bar of the statute of limitations to open an otherwise closed taxable year. Petitioners argue that if the Lil David stock became worthless in 1977, a closed year, "any amounts not allowed in 1978 should be allowed in prior year(s) in accordance with I.R.C. sec. 1311." For the mitigation provisions to apply, there must be a prior "determination," as defined in sec. 1313, that establishes the correct treatment for a disputed item. See sec. 1311(a). A "determination" under sec. 1313(a) means: (1) A final decision by the Tax Court or other court of competent jurisdiction; (2) a closing agreement made under sec. 7121; (3) a final disposition of a claim for a refund; or (4) an agreement pursuant to the regulations issued under sec. 1313. There is no evidence in this case of a prior determination and, therefore, the mitigation provisions cannot apply at this time.

[9] Respondent nevertheless concedes that petitioners are entitled to a $3,000 capital loss deduction for 1978, the maximum amount allowable for that year. Respondent acknowledges that petitioners have a capital loss carryover from 1976 based on petitioner's stock interest in another corporation, Pan Pacific Golf, Inc.

[10] Respondent contends that if petitioners have an ordinary loss under sec. 1244 that is claimable in 1977, the loss would be fully used in closed taxable years and would not carry over to 1978. Because of our holding that petitioners do not have a loss under sec. 1244, we need not consider this contention.

During 1977 Lil David suffered devastating reverses. Sales had dropped to near zero. Ruinous competition persisted. The assets of the corporation were attached. Money could no longer be raised. In short, the corporation lost its economic vitality.

In the absence of persuasive proof that Lil David's stock had value as of January 1, 1978, petitioner's relinquishment of hope for Lil David's revival and total cessation of efforts on its behalf do not constitute identifiable events fixing the loss in 1978. We, accordingly, hold that petitioner's stock in Lil David became worthless in 1977.

Addition to Tax for Late Filing

On a return filed after its due date, section 6651(a)(1) imposes an addition to the tax required to be shown on the return. The addition is 5 percent in the case of a return filed less than one month late. A taxpayer may avoid this addition by establishing reasonable cause for filing late. If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. Sec. 301.6651-1(c)(1), Proced. & Admin. Regs.

Petitioners filed their joint individual income tax return for 1978 on April 23, 1979. The due date was April 16, 1979. At trial, petitioners offered no evidence of reasonable cause for failing to file their 1978 return on time and, on brief, conceded the issue. We, accordingly, hold as correct the 5-percent addition to tax determined by respondent in the deficiency notice.

To reflect concessions,

Decision will be entered under Rule 155.

Ju 11.7/2:1986-66

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T. C. Memo. 1986-66

UNITED STATES TAX COURT

KOLLSMAN INSTRUMENT CORPORATION, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9289-72. Filed February 11, 1986.

Paul A. Teschner, for the petitioner.

Vikki Pryor, for the respondent.

MEMORANDUM OPINION

WRIGHT, Judge*: Respondent determined an overassessment of $137,840 and a deficiency of $2,330,954 in petitioner's Federal income taxes for 1965 and 1966, respectively. After concessions by the parties, two issues remain for decision: (1) whether

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* By order of the Chief Judge this case was reassigned from Judge Darrell D. Wiles to Judge Lawrence A. Wright for disposition.

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petitioner is entitled to a deduction of $4,359,000 on its 1966 return to reflect a loss from a long-term contract, income from which was reported in the taxable years 1963, 1964, and 1965 (the contract issue) and (2) whether petitioner's expenditures of $868,000, $2,114,000, and $1,389,000 in 1966, 1967, and 1968, respectively, were properly deducted in those years as research and development costs pursuant to section 174[1] (the research and development issue).[2]

The facts have been stipulated and are found accordingly. The stipulation of facts and accompanying exhibits are incorporated herein by this reference.

At all times relevant to this case, Kollsman Instrument Corporation (Kollsman or petitioner) was a New York corporation. From its incorporation until December 29, 1972, Kollsman was a wholly owned subsidiary of Standard Kollsman Industries, Inc. (SKI), an Illinois corporation. On that date, SKI, pursuant to a plan of reorganization, merged into Sun Chemical Corporation (Sun), at which time Kollsman became the Kollsman Instrument Company Division of Sun.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Alleged research and development costs which were deducted in 1967 and 1968 are at issue here by virtue of their effect on the net operating loss carryback adjustment for 1965.

The Contract Issue

In November 1962, Kollsman and the Air Force entered into a contract (the letter contract) under which Kollsman agreed to furnish the services and materials necessary to conduct the engineering investigation and the fabrication of an airborne data collection subsystem and a ground data processing subsystem. The letter contract specified a maximum price of $6,728,986 and further specified $3,364,493 as the maximum amount for which the government would be obligated upon termination of that contract. The letter contract also contained the parties' agreement to execute a definitive fixed price contract in 1963. Such a contract (the negotiated contract) was signed by Kollsman on April 4, 1963, and was signed and approved by the Air Force in May 1963. The negotiated contract superseded the letter contract, although certain requirements of the letter contract were not changed. Under the negotiated contract Kollsman agreed to fabricate operational prototypes of a geodetic and photo mapping system and a ground data processing subsystem. In March 1964 the Air Force awarded Kollsman a separate contract (the production contract) for the manufacture of that system.

The negotiated contract contained the following "Changes" clause, standard in government contracts:

> 2. CHANGES
>
> The Contracting Officer may at any time, by a written order, and without notice to the sureties, make changes, within the general scope of this contract, in any one or more of the following: (i) Drawings, designs, or specifications, where the supplies to be furnished are to be specially manufactured for the Government in accordance therewith; (ii) method of shipment or packing; and (iii) place of delivery. If any such change causes an increase or decrease in the cost of, or the work required for, the performance of any part of the work under this contract, whether changed or not changed by any such order, an equitable adjustment shall be made in the contract price or delivery schedule, or both, and the contract shall be modified in writing accordingly. Any claim by the Contractor for adjustment under this clause must be asserted within 60 days from the date of receipt by the Contractor of the notification of change; * * * Failure to agree to any adjustment shall be a dispute concerning a question of fact within the meaning of the clause of this contract entitled "Disputes." However, nothing in this clause shall excuse the Contractor from proceeding with the contract as changed.

In the course of performance of the negotiated contract, engineers from Kollsman and the Air Force jointly worked out agreements on many engineering, design, specification, and production changes. Pursuant to the Changes clause, the Air Force periodically incorporated such changes in formal Contract Change Notifications (CCNs). CCNs were issued with respect to the negotiated contract on June 21, 1963, on November 29, 1963, and on May 26, 1964. Each subsequent CCN superseded and canceled the prior one. The CCNs did not necessarily precede the implementation of the changes. In some instances the changes were not yet accomplished; in others, they were ongoing; and, in still others, they had been completed prior to the issuance of the CCN by the contracting officer. Although each CCN stated the Air Force's unilateral view of the effect on its appropriated funds of the estimated increase or decrease in price resulting from the CCN, such statements were for administrative purposes only and did not affect the rights of either party to negotiate an equitable adjustment pursuant to the Changes clause. The CCNs did not reflect any agreements between the Air Force and Kollsman with respect to the impact of the requested changes upon petitioner's costs, the delivery schedule of the program, or the contract price.

For the years 1963, 1964, and 1965, the costs records of Kollsman's Systems Management Division were separately maintained for the negotiated contract and for the production contract, but such records did not separately identify costs incurred with respect to changes made pursuant to CCNs. There are no books and records available from which such distinction or separate identification could be made. At the end of the respective years 1963, 1964, and 1965, Kollsman was unable to estimate or quantify the extent to which costs had been incurred under the negotiated contract and, consequently, at those times it could not estimate or quantify the total costs expected to be incurred for CCN changes.

The negotiated contract contained the standard "Disputes" clause, which provided, in part, that any factual disputes (i.e., cost of a change) arising under such contract which could not be disposed of by agreement between the parties could be submitted by Kollsman to a contracting officer, whose resolution of the question would be final unless reversed by the Secretary of

Defense or, subsequently, by a court of competent jurisdiction upon timely appeal. On December 30, 1964, Kollsman submitted to the Air Force a Request for Equitable Adjustment of the price and delivery schedules for the negotiated contract. Kollsman claimed $5,146,137 as its additional cost on the negotiated contract and $395,157 profit, for a total claim of $5,541,294. On June 30, 1965, it revised that document to reflect subsequent changes and claimed $5,134,088 as its additional cost and $394,117 profit, for a total of $5,528,205.

Despite numerous meetings during 1965, representatives of Kollsman and the Air Force were unable to reach a consensus and finally agreed to disagree on the merits of Kollsman's claim. On January 10, 1966, the Air Force contracting officer issued his final decision which denied, in part, Kollsman's request for an equitable adjustment, and determined that Kollsman was entitled only to an additional $123,780 with respect to the changes under the negotiated contract. A supplemental agreement to that contract with an effective date of November 17, 1966, authorizing an increase in price of $123,780 was approved by Kollsman on March 9, 1967, and by the Air Force on March 10, 1967.

On September 22, 1966, Kollsman filed with the Armed Services Board of Contract Appeals an appeal from the contracting officer's January 10, 1966, decision on its equitable adjustment claim. That appeal was superseded by an amended complaint filed April 14, 1967. A supplemental agreement and modification of the negotiated contract with an effective date of June 15, 1967, authorizing an increase in price of $1,876,220 was approved by the Air Force on September 26, 1967. This amount plus the $123,780 previously awarded (a total of $2,000,000) was awarded by the Air Force in full settlement of Kollsman's claim for equitable adjustment and appeal thereon and such award effectively settled the complaint filed before the Armed Services Board of Contract Appeals.

At all relevant times Kollsman kept its books and records and, in general, reported its income and expenses for tax purposes using the accrual method of accounting. Kollsman used the cost percentage of completion method to account for the contracts here in question.

On its 1966 return, Kollsman claimed a deduction of $4,359,000 which represented its adjustment for an overreporting of sales income in 1963, 1964, and 1965 with respect to the government contracts. On its 1967 return, Kollsman claimed a deduction of $3,318,000 with respect to the negotiated contract and the production contract. The parties agree that at least $2,359,000 of the 1967 amount is attributable to the negotiated contract and is a duplication of the $4,359,000 deduction in 1966 less the $2,000,000 final settlement award on that contract.

The Research and Development Issue

During 1966, 1967, and 1968, Kollsman incurred various expenses with respect to other contracts to which it was a party, including the following: the KS-200 Contract, by which Kollsman agreed to produce for the Boeing Company (Boeing) the Boeing 737 Air Data Computer; a contract by which Kollsman agreed to provide the Air Force with AAU-19 Altimeters; the Boeing 4289 and 4292 Contracts, under which Kollsman agreed to provide Boeing with Altimeters for the 747 Aircraft; and the Matie AAU-21A Project Contract, by which Kollsman agreed to produce the AAU-21A Altimeter for the Department of the Navy. On its Federal income tax returns for 1966, 1967, and 1968, Kollsman claimed deductions of $868,000, $2,114,000, and $1,389,000, respectively, for alleged research and development costs incurred in the performance of the above contracts. All expenses other than the claimed research and development costs were amortized over a three-year period.

Insofar as is relevant here, in his notice of deficiency for 1966, respondent disallowed petitioner's deduction of $4,359,000 for overaccrued income from the long-term contract and also disallowed petitioner's deduction of $868,000 for claimed research and development costs. Respondent capitalized the latter amount over three years, thereby allowing a deduction of $289,000 (868,000 ÷ 3) in 1966. Deductions in 1967 and 1968 for claimed research and development expenses were also capitalized by respondent. These deductions resulted in net operating losses, which were carried back and used in computing the refund due petitioner based on the overassessment for 1965.

Legal Discussion

The first issue for decision is whether petitioner is entitled to a deduction on its 1966 Federal income tax return to reflect a loss from a long-term contract, income from which was reported, using the percentage of completion method of accounting, in the taxable years 1963, 1964, and 1965.

The regulations allow taxpayers to report income from long-term contracts under the percentage of completion method, the completed contract method, or any other method that clearly reflects income. Sec. 1.451-3(a), Income Tax Regs. Petitioner in the instant case reported the income from its contracts with the Air Force under the percentage of completion method. That method provides that the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year must be included in gross income for such taxable year. Sec. 1.451-3(c)(1), Income Tax Regs. The determination of the percentage of completion of a contract may be made by comparing, as of the end of the taxable year, (1) the costs incurred with respect to the contract with the estimated total contract costs or (2) the work performed on the contract with the estimated total work to be performed. The taxpayer has broad discretion in computing income or loss under the percentage of completion method because the regulations permit any method of cost comparison so long as it is consistently applied and clearly reflects income. Sec. 1.451-3(c)(2), Income Tax Regs. The regulations provide, in general, that "where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made." Sec. 1.451-1(a), Income Tax Regs.

Respondent does not contend, with respect to 1963, 1964, and 1965, that petitioner's accrual of income under the percentage of completion method was improper or that its estimates were unreasonable. Instead, respondent argues, inter alia, that the deduction here at issue was improper because the amount of that deduction did not become certain until 1967 and, thus, could not properly be taken before that time. For the following reasons we agree with respondent.

On January 10, 1966, the Air Force contracting officer made a determination that Kollsman was entitled to only $123,780 as a result of its equitable adjustment claim. On September 22, 1966, Kollsman appealed that determination to the Armed Services Board of Contract Appeals. That appeal was superseded by an amended complaint filed April 14, 1967. Petitioner's appeal was not resolved until September 26, 1967, by the execution of a modification contract which allowed the equitable adjustment claim in the amount of $2,000,000, including the $123,780 already allowed. These facts establish that at the close of its 1966 taxable year, an appeal was pending on petitioner's claim for equitable adjustment. During the pendency of the appeal petitioner was unable to determine the exact amount which it would receive under the government contracts, and, therefore, it could not determine the difference between the amount of income already accrued and the exact amount of income it would receive. See sec. 1.451-1(a), Income Tax Regs. Thus, in 1966 petitioner had no basis upon which to claim a loss and, in any event, had no means of calculating the amount of any such loss. Accordingly, we sustain respondent's determination that the deduction taken on the 1966 return was improper.

The second issue for decision is whether petitioner is entitled to a deduction under section 174 for claimed research and development expenditures.

As a preliminary matter, we note that deductions are a matter of legislative grace; the taxpayer must satisfy the specific statutory requirements of the deductions claimed to reduce his tax liability. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Respondent's determinations are presumptively correct and petitioner bears the burden of proving its entitlement to any deduction. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Section 174(a) provides that a deduction shall be allowed for research and experimental expenditures which are paid or incurred during the taxable year in connection with the taxpayer's trade or business. The term "research or experimental expenditures" is defined in the regulations as "expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned." Section 1.174-2(a), Income Tax Regs. In considering the above definition, this Court found it to be "consistent with the intent of the statute to limit deductions to those expenditures of an investigative nature expended in developing the concept of a model or product." Mayrath v. Commissioner, 41 T.C. 582, 590 (1964) (emphasis in original), affd. without discussion on this issue 357 F.2d 209 (5th Cir. 1966).

Respondent maintains, generally, that petitioner's claimed research and development costs are not deductible in the year in which they were incurred but must be amortized over three years. He concedes that petitioner incurred expenses in the amounts claimed and that such expenses were connected with petitioner's trade or business, but he contends that the expenditures at issue are not research and experimental expenditures within the meaning of section 174. Petitioner argues, however, that its contracts specifically provide that Kollsman perform duties of a research and experimental nature.

In attempting to establish entitlement to deductions under section 174, petitioner quotes extensively from the contracts under which the alleged research and experimental duties were performed. By selectively quoting from such contracts, petitioner apparently is attempting to highlight those segments which, when read alone, could be interpreted as requiring Kollsman to perform design activities, produce prototypes, and engage in pre-operation testing. Repetition here of the quoted material would serve no purpose. It is sufficient to say that after careful review of the submitted documents, we conclude that the contracts here in question did not require Kollsman to invent or to develop the concept of or to design any product. Rather, such contracts can fairly be characterized as production contracts under which Kollsman agreed to manufacture or produce certain equipment in accordance with designs furnished to it. Because we find that these are production contracts, which did not require petitioner to perform duties of an experimental nature, petitioner's expenditures are not deductible as research and experimental expenditures, within the meaning of the statute.

By way of illustration, several of the contracts in question were entered into after Kollsman's submission of a proposal pursuant to invitations to do so by the various buyers. Such invitations set forth specifications and requested that cost proposals be prepared for the production of certain items in accordance therewith. In several instances, these proposals were to be submitted for the indicated incremental quantities which, in the case of the AAU-19 contract, ranged from 1,201 to 1,576. Price schedules for several of the contracts in question listed unit price and total price; the unit price sometimes varied as the required quantity changed. Several of the proposals and resultant contracts set forth production and/or delivery schedules for the items produced. For example, with respect to the KS-200 Contract, Boeing provided Kollsman with "Boeing 737 Air Data Computer Specification 10-61229" and invited Kollsman to submit a cost proposal which contemplated production and delivery of the first complete configuration by February 1, 1966, and further provided for production and delivery of one shipset in August 1966, two shipsets per month from September 1966 through September 1967, and between five and nine shipsets per month thereafter. After submitting its proposal, Kollsman and Boeing entered into a general terms agreement applicable to the purchase and sale of the "Kollsman Air Data Computer KS-200 as set forth in Detail Specification No. 10-61229." Based on our review of the entire record in this case including the foregoing, we find that petitioner has failed to prove that it incurred research and experimental expenditures within the meaning of the statute.

Moreover, even if we were to assume that research and experimental expenditures were incurred with respect to petitioner's contract with Boeing, it is impossible to determine, on the basis of the evidence submitted, what portion, if any, of the claimed research and experimental expenditures was properly classified. The amount claimed by petitioner is not broken down in any way to indicate the nature and amount of the expenses which constitute the deductions of $868,000, $2,114,000, and $1,389,000 in 1966, 1967, and 1968, respectively. We are not persuaded by petitioner's bare assertion that expenditures in these amounts were attributable to research and experimental costs with respect to various contracts. Nor is the fact that petitioner deducted certain expenses and capitalized others conclusive as to the character of the deducted expenditures or the propriety of such deductions. Petitioner bears the burden of proof in this matter. Welch v. Helvering, supra. We find that petitioner has failed to prove either its entitlement to or the amount of its deductions under section 174. See generally Coors Porcelain Co. v. Commissioner, 52 T.C. 682, 697-698 (1969), affd. 429 F.2d 1 (10th Cir. 1970).

Petitioner maintains that respondent has introduced no evidence challenging either the accuracy of petitioner's books and records or the attestations, signed by petitioner's officers as part of its tax return, that such returns were correct. Petitioner argues, therefore, that the presumption of correctness usually accorded respondent's determination should not be applied here, citing *Weimerskirch v. Commissioner*, 596 F.2d 358 (9th Cir. 1979), revg. 67 T.C. 672 (1977). In *Weimerskirch*, the Commissioner determined a deficiency based upon the taxpayer's failure to report income he allegedly received from selling heroin. The Court of Appeals for the Ninth Circuit, expressly addressing only the facts of that particular case, held that the Commissioner was not entitled to rely on the presumption of correctness unless he offered some substantive evidence linking the taxpayer to the sale of narcotics or showing that the taxpayer received income from the charged activity. *Weimerskirch v. Commissioner*, *supra* at 361-362. The facts of that case are, however, fundamentally distinguishable as there is no allegation in the instant case of unreported income from any source, legal or illegal. Petitioner's reliance on *Weimerskirch* is misplaced. Cf. *Karme v. Commissioner*, 673 F.2d 1062 (9th Cir. 1982), affg. 73 T.C. 1163 (1980). Accordingly, we will apply the general rule under which the Commissioner's determination is presumptively correct and petitioner bears the burden of proving otherwise.

See generally Dellacroce v. Commissioner, 83 T.C. 269 (1984) and cases cited therein. Based on the foregoing, petitioner has failed to meet this burden.

Finally, petitioner contends that it should be relieved of the obligation to meet its burden of proof and argues that it should not be penalized for its failure to produce sufficient evidence because such failure is attributable to the unavailability of Kollsman employees with knowledge of the subject at issue, due to the long period during which this case remained pending. Petitioner also urges that, at the least, this Court should apply the rule of Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), to treat a portion of Kollsman's expenses as research and experimental expenditures. We are not persuaded by either of petitioner's arguments. That petitioner bears the burden of proof in this case is in accordance with the Rules of this Court and with case law. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933). We may not dispense with such precedent in order to relieve the burden imposed upon petitioner under the law, nor would we be inclined to do so where, as here, petitioner's difficulty is of its own making. Although the petition in this case was filed in December 1972, the issues in this case were not submitted to this Court for consideration until some 11 years later because of the numerous continuances granted upon petitioner's requests. We do not find, nor do we suggest, that petitioner has unnecessarily delayed this case.[3] Nevertheless, on this record, we find no basis upon which to suspend or adjust the rules of this Court.

We must also decline petitioner's request that we apply the Cohan rule to find at least a portion of its expenses deductible under section 174. First, petitioner has failed to establish to our satisfaction that any of its expenses were of the type that could properly be deducted under that section. Furthermore, on the record before us petitioner has presented nothing upon which we could make the approximation permitted by Cohan.

To reflect the foregoing and concessions by the parties,

Decision will be entered
under Rule 155.

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[3] The long period of time between the filing of the petition and the submission of this case is due, primarily, to the pendency in the Court of Claims of a suit involving the same issue as this case. See Sun Chemical Corp. v. United States, 698 F.2d 1203 (Fed. Cir. 1983), affg. an unreported decision of the United States Claims Court, cert. denied 464 U.S. 819 (1983).

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T. C. Memo. 1986-67

UNITED STATES TAX COURT

JO MOONYEEN HODGES, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19682-80. Filed February 12, 1986.

Larry A. Koch, for the petitioner.

Bruce K. Meneely, for the respondent.

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SUPPLEMENTAL MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: In T.C. Memo. 1985-56,[1] we found that a 1976 income tax return executed by petitioner and her former husband was intended to be a joint return and was not the result of duress. After trial of the issue of duress but prior to release of our opinion on that issue, petitioner sought leave to amend her petition to allege that she was entitled to relief as an innocent spouse under section 6013(e),[2] as amended by section 424 of the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 494, 801-803. Because the cited legislation applies to all actions pending as of its effective date, we permitted the amendment as to the following adjustments in the statutory notice of deficiency disallowing expenses claimed with respect to a contract equipment sales business operated by petitioner's former spouse, Lloyd L. Hodges (Hodges):

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[1] In footnote 2 of our Memorandum Findings of Fact and Opinion, T.C. Memo. 1985-56, we chastised petitioner for raising an issue for the first time in her opening brief. We were in error. The question of whether a certain business was or was not community property was raised during a colloquy between counsel for both parties at the commencement of trial on the duress issue. Respondent's counsel then took the position that, if petitioner were to prevail on the issue of duress, respondent would pursue the alternative contention that there was a deficiency in tax due from petitioner on her income during 1976, including community property income.

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

Item	Amount
Depreciation:	
Cadillac	$ 1,399.99
Oldsmobile	869.75
Pontiac	849.99
Insurance expense	4,026.96
Bad debt expense	3,016.70
Travel and entertainment expense	10,071.48
Meal expense	4,022.94

The parties have stipulated that the foregoing adjustments increased taxable income of petitioner and Hodges for 1976 by $23,257.81; that the understatement of tax liability attributable to the items is $18,074.16; and that those items are grossly erroneous items as defined in section 6013(e)(2), as amended.

Respondent contends that petitioner is not entitled to relief as an innocent spouse because the items are not "attributable to" Hodges; that petitioner knew or had reason to know that there was a substantial understatement of tax; that petitioner substantially benefitted from the understatement of tax, and it would not be inequitable to hold her liable for the deficiency in tax; and that petitioner failed to prove that the substantial underpayment of tax exceeded the required percentage of her adjusted gross income for 1979, which the parties have stipulated is the "preadjustment year" as defined in section 6013(e)(4)(C).

SUPPLEMENTAL FINDINGS OF FACT

On or about June 1, 1976, Hodges, d/b/a Lloyd L. Hodges Company (the business), was conducting his contract equipment sales business in Chicago, Illinois. During 1976, petitioner assisted Hodges in his business in Chicago. The books and records of the business were moved from San Diego, California, to Chicago. A business bank account was maintained at the First National Bank of East Chicago, and petitioner had signature authority on that bank account. Petitioner wrote checks on the bank account to pay household expenses and acquire groceries for use at the Chicago site.

In 1976, petitioner and Hodges purchased a residence in San Diego for approximately $250,000, with a downpayment of approximately $100,000. During 1976 or 1977, Hodges purchased two other parcels of real property in San Diego, a parcel of real property in Tulsa, Oklahoma, and a substantial amount of equipment in Saskatchewan, Canada. Petitioner was aware of each of these purchases at the time they occurred.

When she signed the joint income tax return for 1976, petitioner did not determine whether the amounts of income reported or the amounts of expenses claimed on the return were correct. Petitioner was reluctant to sign the return because Hodges indicated that he did not intend to pay the reported tax due ($315,341.83). Hodges stated to petitioner that they were not going to pay the taxes and were going to take the money and go to Brazil. Shortly prior to the time that she signed the return, petitioner was injured, either in a fall or because she was struck by Hodges. Shortly after she signed the return, petitioner and Hodges separated.[3]

In the judgment rendered in 1979 in the divorce action between petitioner and Hodges, in addition to the amounts set forth in our prior opinion (page 4), the California court awarded to petitioner a money judgment in the amount of $680,464 and spousal support in the amount of $3,400 per month, commencing on May 10, 1979, and to continue for 36 months, unless sooner terminated. Although petitioner received $12,000 or $14,000 cash subsequent to execution of that judgment, and although proceeds of sale of the San Diego residence amounting to $43,000 were applied to her income tax liabilities, a substantial amount of the award was uncollected through August 1985. Litigation between petitioner and Hodges continued at least through that time over the assets accumulated by them during their marriage.

During 1979, petitioner continued to operate her model maintenance business. She had gross income from that business during 1979 of not less than $5,972.05 and net income of not less than $2,873.52. Petitioner did not file an income tax return for 1979.

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[3] As indicated in our prior opinion, T.C. Memo. 1985-56, the evidence is conflicting as to how petitioner's injuries occurred. Our decision that the return was not executed under duress, for reasons stated in that opinion, would be the same even if we assumed that Hodges struck petitioner. The fact of her injury, from whatever source, is material to the question of whether she had actual knowledge of the erroneous items on the return.

Each of the items now in dispute were deducted on the Schedule C of the 1976 return prepared for the contract equipment sales business. The item disallowed for depreciation on a Cadillac related to an automobile purchased in 1976 and sometimes used by petitioner. The disallowed item relating to insurance was for life insurance on the life of Hodges. The item disallowed as a "bad debt" related to money advanced to or for petitioner's son.

ULTIMATE FINDING OF FACT

Taking into account all the facts and circumstances, it is not inequitable to hold petitioner liable for the deficiency in tax in issue.

OPINION

Section 6013(e)(1), as amended, provides as follows:

> (e) Spouse Relieved of Liability in Certain Cases.--
>
> (1) In general.--Under regulations prescribed by the Secretary, if--
>
> (A) a joint return has been made under this section for a taxable year,
>
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,
>
> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.[4]

Petitioner has the burden of showing that she meets each of the requirements of the above section. Welch v. Helvering, 290 U.S. 111 (1933); Sonnenborn v. Commissioner, 57 T.C. 373, 381-383 (1971); Rule 142(a), Tax Court Rules of Practice and Procedure.

Petitioner contends that it would be inequitable to hold her responsible for the deficiency attributable to expenses claimed in relation to the contract equipment sales business operated by Hodges. She argues that she was prevented from having access to the books and records of the business from which the correct tax liability could have been determined and that she was not allowed to examine the 1976 return prior to signing it. She asserts that she has not collected the moneys that were awarded to her by the California court and that she did not benefit from the deductions claimed. She continues to insist that she signed the return only after she was beaten by Hodges.

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[4] The parties also disagree as to whether petitioner has proven that she satisfies the requirements of section 6013(e)(4), which provides in part:

> (A) Adjusted gross income of $20,000 or less.--If the spouse's adjusted gross income for the preadjustment year is $20,000 or less, this subsection shall apply only if the liability described in paragraph (1) is greater than 10 percent of such adjusted gross income.
>
> (B) Adjusted gross income of more than $20,000.--If the spouse's adjusted gross income for the preadjustment year is more than $20,000, subparagraph (A) shall be applied by substituting "25 percent" for "10 percent."

In view of our holding, we need not resolve this dispute.

On consideration of the entire record, including the evidence presented on two separate occasions (June 8, 1984, and August 5, 1985), we conclude that the determinable facts and circumstances found here and in our prior opinion do not lead to the conclusion that it would be inequitable to hold petitioner liable for the deficiency attributable to deductions disallowed in relation to the contract equipment sales business. During the year in issue, petitioner participated to some extent in the operation of that business. She had use of one or more of the vehicles on which depreciation was erroneously claimed, and she personally wrote checks on the business account for groceries and household expenses. The purported bad debt related to payments for her son. Petitioner has not shown that the items disallowed for meals and lodging and travel and entertainment were not related to personal expenses incurred by Hodges and petitioner. All of the deductions claimed were obviously intended to reduce the tax liability of the parties shown on the joint return, and if they had not been claimed, both petitioner and Hodges would have been liable for the correct amount of tax. Petitioner was well aware during 1976 that substantial funds were being expended on the purchase of real and personal property, as well as living expenses of Hodges and petitioner. When the parties were divorced in 1979, the California court's award of over $1 million to petitioner and her attorneys and accountants was based in part on that court's determination that the business was community property of petitioner and Hodges.

In determining whether it is inequitable to hold petitioner responsible for the items in issue, it is significant that petitioner was at least indifferent to her own compliance with the income tax laws. She conceded that in 1976 she had unreported income of $9,916.54 from her own model maintenance business and that in 1979 she did not file a tax return reporting income from that business. Her admitted gross receipts from the business were sufficient to require the filing of a return during that year. Section 6012(a)(1)(A)(i). Yet, she offered no excuse for her failure to comply with her own obligations. Moreover, we are not persuaded by her testimony that in 1979 she survived on net income from her business of $2,873.32 plus a $16,000 loan received from her mother on some prior occasion. The testimony is vague, uncorroborated, and improbable.

Although our determination that it is not inequitable to hold petitioner liable for the items in dispute is dispositive of the issue herein, we also find on this record that petitioner has not met other requirements of section 6013(e)(1). Because of their joint involvement in operating the contract sales equipment business, we conclude that the erroneous items are "attributable to" both petitioner and Hodges. Moreover, in view of petitioner's disbursement of business funds for personal purposes, we conclude that she had reason to know that improper deductions were claimed and that there was be a substantial understatement of tax on the return prepared at the instance of Hodges. Section 6013(e)(1)(C). She certainly has not satisfied her burden of persuading us otherwise.

To take into account the effect of a stipulation filed herein August 4, 1983,

Decision will be entered
under Rule 155.

742-B Ju 11.7/2:1986-68

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MF113

T. C. Memo. 1986-68

UNITED STATES TAX COURT

GREGORY KOUROUKLIS, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13330-84. Filed February 12, 1986.

> Petitioner, who had to switch from carpooling to use of his own car to get to and from his place of employment, in order to put his minor children on school buses in the mornings, may not deduct the difference in the cost of his transportation as child care expense.

Gregory Kourouklis, pro se.

Richard F. Stein, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DRENNEN, *Judge*: Respondent determined a deficiency in the amount of $298.58 in petitioner's Federal income tax for the taxable year 1981.

ORIGINAL

The issue for decision is whether additional transportation expenses incurred by petitioner in commuting to work individually in his own car rather than participating in a car pool are includable in the computation of a credit under section 44A, Internal Revenue Code, effective for the year 1981.[1]

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference. To facilitate our disposition of this case, we will combine our findings of fact and opinion.

Gregory Kourouklis (petitioner), resided in Fredericksburg, Virginia at the time he filed his petition in this case. He filed a timely individual Federal income tax return for the taxable year 1981 with the Internal Revenue Service Center in Memphis, Tennessee.

During 1981, petitioner was employed as an engineer for the U. S. Navy at the Naval Surface Weapons Center in Dahlgreen, Virginia. Prior to 1981 petitioner travelled to and from his job site in a car pool. Petitioner had separated from his wife in 1976 and was later divorced. Petitioner had legal custody of their three children, Stacy Charles, 14, Catherine Elizabeth, 12, and James Duncan, 8.[2] The children caught a bus to school everyday between 8:00 a.m. and 8:30 a.m. They returned home around 3:30 p.m. The children were cared for in petitioner's home by Dee Duncan (Ms. Duncan), a family friend. Ms. Duncan did not accept payment for her services. However, petitioner did provide her with a room and with her meals. On his 1981 return, petitioner included as part of his credit under section 44A the expense he incurred for Ms. Duncan's meals. Respondent did not contest this adjustment.

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[1] All section references are to the Internal Revenue Code of 1954, as amended, and in effect during the taxable years at issue. Section 44A was redesignated as Section 21(a) by Pub.L. 98-369, 98 Stat. 826,effective for years beginning after December 31, 1983.

Sometime in 1981, Ms. Duncan decided to move to Michigan and therefore ceased to care for the children. Petitioner sought to hire someone to care for the children in the early mornings from 6:30 a.m. to 8:30 a.m., after he left with his car pool for work, and in the afternoon from 3:30 p.m. to 5:30 p.m., until he returned home. He checked with the Virginia Employment Commission and with Mary Washington College but was unable to find anyone to care for the children during that time. He therefore decided to give up his car pool and to commute individually in order to be at home in the morning to care for his children. In the evenings the oldest child, Stacy Charles, was to care for the younger two children and petitioner asked the neighbors to keep an eye on the children in case of an emergency. Petitioner then included on his tax return for 1981 the additional costs he incurred for commuting individually above the cost he would have incurred for his car pool in his credit under section 44A. Respondent disallowed this portion of the credit.

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[2] The ages reflected are the approximate ages of the children in 1981, the taxable year at issue, as determined from petitioner's testimony.

We must determine whether the additional transportation costs incurred by petitioner are includable in the computation of a credit under section 44A.[3]

Petitioner contends that the additional expense he incurred in commuting individually to his place of employment rather than with a car pool is includable under section 44A. He argues that the expense was incurred for child care purposes since he chose to commute individually in order to be home in the mornings to care for his children. He further contends that respondent acted inconsistently by allowing a credit for the "increase in his grocery bill" as a result of providing meals for Ms. Duncan but not allowing a credit for the "additional expense created by the family car."

It is respondent's position that the expenses incurred by petitioner in commuting to and from work were a nondeductible, personal expense. Respondent contends that nowhere in section 44A is there any language from which one could infer that commuting expenses can be viewed as "employment-related expenses" for purposes of a tax credit. Therefore, respondent concludes that his determination, denying the credit, should be sustained.

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[3] Sec. 44A was amended by sec. 124 of Pub. L. 97-34, 95 Stat. 172, 197, Aug. 13, 1981, effective for the taxable years beginning after Dec. 31, 1981.

Section 44A allows a credit for expenses incurred for household and dependent care services necessary for gainful employment. The credit allowed is a certain percentage of the "employment-related expenses" paid during the taxable year. Section 44A(c)(2) provides that:

> The term "employment-related expenses" means amounts paid for the following expenses, but only if such expenses are incurred to enable the taxpayer to be gainfully employed for any period for which there are 1 or more qualifying individuals with respect to the taxpayer:
>
> (i) expenses for household services, and
>
> (ii) expenses for the care of a qualifying individual.

Section 1.44A-1(c)(1), Income Tax Regs, explains that expenses are considered to be employment-related expenses only if they are incurred to enable the taxpayer to be gainfully employed and are paid for household services or for the care of one or more qualifying individuals.

Section 262 provides that no deduction is allowed for personal, living, or family expenses unless expressly provided in the Code. Nowhere in section 44A is there a deduction or a credit for personal commuting expenses. Commuting expenses have long been viewed as an expense that is both personal and nondeductible. Sec. 1.162-2(e) and sec. 1.262-1(b)(5), Income Tax Regs. See Commissioner v. Flowers, 326 U.S. 465 (1946).

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Petitioner herein commutes individually for personal reasons (albeit honorable ones); he wants to be at home early in the morning to care for his children. Therefore petitioner's additional transportation expenses incurred to commute individually are not allowed as a credit under section 44A.

Decision will be entered
for respondent.

742-B

JU 11.7/2:1986-69

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MF115

T. C. Memo. 1986-69

UNITED STATES TAX COURT

JOHN D. TONEY, SR. AND MARY R. TONEY, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 29384-84. Filed February 13, 1986.

Petitioner owned all the stock of Real/Tech, a small business corporation. Real/Tech was heavily indebted to petitioner and others and had a note outstanding for $1,500,000 to Commonwealth Federal Savings and Loan on which petitioner was primary guarantor. Petitioner agreed to transfer Real/Tech to CU, an unrelated corporation, and to assume or liquidate all of Real/Tech's liabilities except the note to CFSL. CU agreed to assume primary liability for the note, to issue 25 additional shares of Real/Tech stock to petitioner, and to give petitioner an option to purchase certain real estate.

Held: Petitioner is not entitled to deduct his losses on the transfer of Real/Tech as ordinary losses under section 1244 of the Internal Revenue Code. Petitioner's advances to Real/Tech did not establish a true indebtedness from Real/Tech to petitioner so petitioner's forgiveness of the liability supposedly in exchange for the 25 shares of stock did not qualify the stock as section 1244 stock.

ORIGINAL

H. Lawrence Yancey, for the petitioners.

Howard P. Levine, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DRENNEN, Judge: Respondent determined deficiencies[1] in petitioners' Federal income tax as follows:

Year	Deficiency
1976	$2,220.00
1977	5,822.00

After concessions by both parties, the issue remaining for our decision is whether petitioners are entitled to ordinary loss deductions in connection with certain stock issued by a corporation in exchange for cancellation of indebtedness under section 1244.[2]

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts, supplemental stipulation of facts, and joint exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

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[1] These deficiencies were determined as a result of petitioners' carryback of a net operating loss from 1979 to 1976 and 1977.

[2] All section references are to the Internal Revenue Code of 1954, as amended, and in effect during the taxable years at issue. All rule references are to the Tax Court Rules of Practice and Procedure.

Petitioners John D. Toney, Sr. and Mary R. Toney are husband and wife whose legal residence was Little Rock, Arkansas at the time they filed their petition in this case.[3] Petitioners filed a timely joint Federal income tax return for 1979 with the Internal Revenue Service Center in Austin, Texas.

During the years at issue, petitioner was employed as a real estate agent in Little Rock, Arkansas. He decided to invest in a real estate development project with one Dewey Buffington (Buffington). In 1972, petitioner and Buffington purchased a 300 acre tract of land in Little Rock, Arkansas for development into residential real estate.[4] They obtained a loan of $2.6 million from Commonwealth Federal Savings and Loan (CFSL)[5] with which to purchase the property. Petitioner, Buffington, and their wives were listed as personal guarantors on the loan.

On September 28, 1972, petitioner and Buffington formed a corporation called Tall Timber Development Corporation (Tall Timber or the corporation), for the purpose of engaging in real estate development. Upon forming Tall Timber, petitioner and Buffington each transferred $5,000 to the corporation as a contribution to capital along with the title to the recently acquired property. They each were issued 50 shares of the stock of Tall Timber.6/ The encumbrance on the property was also assigned to Tall Timber. However petitioner and Buffington remained primarily liable on the note. The property, later named Pecan Lake, was divided into a residential subdivision of 302 lots.

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[3] All references to "petitioner" refer to John D. Toney, Sr.

[4] The record does not indicate how title to this property was held.

[5] CFSL subsequently merged with Superior Federal and continued in business as Superior Federal. To avoid confusion however we will continue to refer to the bank as CFSL.

Tall Timber was incorporated under the laws of the state of Arkansas. It had one class of stock outstanding and qualified as a small business corporation under section 1244(c)(3). A section 1244 plan was adopted at the first meeting of the incorporators of Tall Timber and was approved thereafter by the Board of Directors.

Shortly after petitioner and Buffington began the development of Pecan Lake the real estate business experienced a slump. Tall Timber had difficulty selling its lots which resulted in it being unable to pay the expenses it incurred, including interest on the debts it incurred. Tall Timber needed additional capital to pay its mounting expenses but was unable to borrow additional funds due to its current indebtedness. Petitioner made several loans to Tall Timber in 1976 to enable it to pay real estate taxes, accounting fees, attorney's fees, and other business debts. The loans were in the amounts of $10,620, $63,204.61, and $18,070.13. The loans were evidenced by

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6/ Respondent has conceded that this initial contribution was pursuant to section 1244 and that the stock issued was section 1244 stock.

promissory notes executed by Tall Timber to petitioner. Petitioner was to be repaid for these loans from later real estate sales. He did not, however, receive any payments of interest or principal.

Tall Timber was having difficulty during this time making payments to CFSL on its $2.6 million loan. CFSL began to exert pressure on Tall Timber to make its interest payments. Tall Timber's difficulty eventually resulted in CFSL filing a suit for foreclosure against Tall Timber on September 8, 1978. The bank was concerned that petitioner and Buffington were having personal conflicts which affected their ability to manage Tall Timber. CFSL advised petitioner that either he or Buffington should purchase the other's interest, or that Tall Timber should be sold to new investors. Shortly thereafter, petitioner purchased Buffington's interest in Tall Timber, and Buffington was released from liability on the CFSL note. CFSL then dismissed their foreclosure suit.

After petitioner purchased Buffington's interest in Tall Timber he decided to change the corporation's name. He felt that Tall Timber had a bad reputation. On January 18, 1979, he changed the name to Real/Tech Corporation (Real/Tech). Petitioner was the president and sole shareholder of Real/Tech. He then took several actions to stimulate sales in Real/Tech including hiring an advertising agency, and purchasing billboards.

Sometime thereafter Dan Robinson (Robinson), a sales agent hired by petitioner to help stimulate sales in Real/Tech, approached petitioner with an offer to purchase his interest in Real/Tech. Robinson was acting as the broker for Construction Unlimited (CU), the actual offeror. Matkin stated that CFSL encouraged petitioner to sell his interest to CU. CFSL was concerned that petitioner was having difficulty communicating with the Pecan Lake Homeowner's Asociation, and that petitioner lacked expertise in building and marketing houses; his experience had been solely in selling real estate. In contrast, Fred J. Brei, Jr. (Brei), who was the sole shareholder of CU, had built houses in the Chicago area. CFSL also felt that petitioner was running out of money and that Brei was more financially sound. Ernest Matkin, who had managed the loan department of CFSL when the loan was originally made, stated that during this time CFSL would not have loaned any more money to petitioner, or to Real/Tech, because of petitioner's difficulty in making payments on the $2.6 million loan, and his lack of expertise in marketing and building houses.

On July 10, 1979, petitioner and Brei signed an agreement for the sale of Real/Tech. Real/Tech was insolvent at the time this agreement was executed. As part of the agreement petitioner was to reduce Real/Tech's liabilities to $1.5 million, which would be owed to CFSL. The remainder of Real/Tech's liabilities were to either be assumed or liquidated by petitioner. CFSL required that for Brei to take title to Real/Tech he had to assume primary liability for Real/Tech's debt to CFSL. Petitioner was to remain secondarily liable. Real/Tech, CU, and Brei executed a new mortgage with CFSL for $1,121,759.85 the proceeds of which were used to retire Real/Tech's prior debt with CFSL. The agreement for CU to purchase Real/Tech was consummated on August 2, 1979.

As of December 1, 1978, Tall Timber had incurred a debt of $109,976.60 with Metropolitan National Bank (Metropolitan). This debt was accumulated by Tall Timber over a period of time on their open line of credit with Metropolitan. Being aware of Tall Timber's financial difficulties, Metropolitan sought additional security for this debt. On August 2, 1979, petitioner executed his promissory note to Metropolitan to pay this debt using a parcel of real property owned by him and his wife as collateral for the debt.

On August 1, 1979, petitioner signed an agreement cancelling all indebtedness owed to him by Real/Tech in return for Real/Tech's issuance to him of 25 shares of stock. This indebtedness amounted to $689,887.17,7/ or $27,595.48 per share.

7/ The record is somewhat confusing as to the sources of this indebtedness. From our reading of the record Real/Tech's debt to petitioner included 3 loans made to Real/Tech in 1976 of $10,620, $63,204.61, and $18,070.13; petitioner's assumption of a loan made to Real/Tech by Metropolitan of $109,976.60; an interest payment made by petitioner to CFSL of $220,000 and various other debts incurred by Real/Tech but paid by petitioner due to Real/Tech's financial difficulties.

Real/Tech was insolvent when the stock was issued. A consent memorandum issued by Real/Tech in connection with the issuance of its stock stated that

> The offer, sale and issue of such shares be effectuated in such a manner that qualified shareholders may receive the benefits of section 1244 of the Internal Revenue Code.

Petitioner then sold his 25 shares of Real/Tech stock to CU. In return, CU assumed primary liability for CFSL's loan to Real/Tech and petitioner was given an option to purchase some of Real/Tech's property.

Petitioners incurred a loss in 1979 of $100,764 on the sale of the stock to CU. They filed an application for tentative refund (Form 1045) with the Internal Revenue Service seeking to carry the loss back to the taxable years 1976 and 1977 on the theory that the loss was an ordinary loss incurred on the sale of section 1244 stock. Respondent disallowed this claim.

OPINION

The issue in this case is whether the loss incurred by petitioners on the sale of stock in Real/Tech to CU qualifies as an ordinary loss under section 1244. The parties agree that the section 1244 plan adopted by Real/Tech was valid and that Real/Tech was a small business corporation as defined in section 1244(c)(3)(A). Hence, we are left with the narrow issue of whether the 25 shares of stock issued to petitioner by Real/Tech constituted section 1244 stock.

Section 1244 provides that, subject to certain conditions and limitations, a loss on the sale or exchange (including a transaction treated as a sale or exchange) of "section 1244 stock" which would otherwise be treated as a loss from the sale or exchange of a capital asset shall be treated as an ordinary loss. See sec. 1.1244(a)-1, Income Tax Regs.

"Section 1244 stock" is defined in section 1244(c)(1) as stock in a domestic corporation if

> (A) at the time such stock is issued, such corporation was a small business corporation,
>
> (B) such stock was issued by such corporation for money or other property (other than stock and securities), and
>
> (C) such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

Section 1.1244(c)-1(d), Income Tax Regs., provides that stock issued in exchange for the cancellation of indebtedness of the corporation is considered to be issued in exchange for money or other property. However, if the indebtedness is evidenced by a security it is not viewed as section 1244 stock. Sec. 1.1244(c)-1(d), Income Tax Regs.

Section 1244 was first enacted as part of the Small Business Tax Revision Act of 1958. Section 1244 was designed to encourage the flow of new funds into small businesses. H. Rept. No. 2198 (1958), 1959-2 C.B. 709, 711. This encouragement was supplied by allowing shareholders an ordinary loss on their investments should they prove unsuccessful. However, only new infusions of capital were to receive this special treatment. Therefore stock or securities of the issuing corporation were excluded as proper consideration for section 1244 stock under section 1244(c)(1)(B). Such consideration would be an influx of an already existing equity interest generating no new capital and not effectuating the purpose of section 1244. H. Rept. 2198, supra; Smyers v. Commissioner, 57 T.C. 189 (1971).

Respondent contends that petitioners should not be allowed an ordinary loss on the sale of their Real/Tech stock to CU because the stock does not qualify as section 1244 stock since it was not issued for money or other property as required by section 1244(c)(1)(B). Rather respondent argues when Real/Tech issued its 25 shares of stock to petitioner the transaction was not an exchange of stock for the cancellation of indebtedness but was instead an exchange of stock for an equity interest in Real/Tech which prevents the stock issued from qualifying as section 1244 stock. The consideration qualifies as an equity interest, respondent contends, because when petitioner paid debts of the corporation he was not loaning money to it but was instead making a capital contribution due to the fact that Real/Tech was insolvent and that it was unlikely that petitioner would ever be repaid, and that the advances that had been made by petitioners and others to Real/Tech were already so deeply committed to

Real/Tech that they must be classified as either "stock or securities." Therefore respondent concludes that petitioners' deduction of an ordinary loss should be disallowed.

To the contrary petitioners argue that the ordinary loss should be allowed because the stock issued by Real/Tech to petitioners was in reality section 1244 stock. Petitioners contend that the stock was issued in exchange for petitioners' cancellation of Real/Tech's indebtedness to him which is valid consideration under section 1244 since it is viewed in the same way as money. Petitioners reject respondent's contention that the notes issued by Real/Tech to petitioners represented in substance equity. Petitioners contend that the paramount consideration in determining whether the notes constituted debt or equity is the parties' intention and that the parties intended for the advances to be treated as an indebtedness, as further evidenced by the formal execution of notes, the requirement that interest be paid, and the fact that payment was not contingent. Therefore petitioners conclude, they should be allowed an ordinary loss on the sale of the section 1244 stock.

For the reasons detailed below, we agree with respondent.

Whether the stock issued to petitioners by Real/Tech was section 1244 stock hinges on the question of whether the consideration exchanged by petitioner for the stock was cancellation of debt or equity. If the consideration exchanged by petitioners was cancellation of a debt then it is viewed the same as money which is valid consideration under section 1244. If, however, the notes petitioner held were already so deeply committed to Real/Tech that its financial position could not be realistically benefitted by any change of characterization then the notes are in reality equity, or risk capital and are insufficient consideration for section 1244 stock. See section 1.1244(c)-1(d). Kaplan v. Commissioner, 59 T.C. 178 (1972). This determination requires a careful examination of all the relevant facts and circumstances. Kelley Co. v. Commissioner, 326 U.S. 521 (1946). Our examination is crucial since it is the substance of the economic relationship, not its form, that determines the incidence of Federal income taxation. Gregory v. Helvering, 293 U.S. 465 (1935).

Several of the factors that will be utilized to assist us in our determination are:

> 1) whether the debt evidenced the formal attributes of indebtedness, e.g., an unconditional obligation to pay a fixed sum on demand or at a fixed maturity date in the not unreasonable future; a fixed rate of interest payable unconditionally; a preference over all classes of stock in liquidation, and an absence of voting rights at any time;
>
> 2) whether the circumstances indicate that the debt could be enforced according to its terms; and
>
> 3) whether the parties were in fact enforcing the debt according to its terms.

Hollenbeck v. Commissioner, 50 T.C. 740, 749 (1968), affd. 422 F.2d 2 (9th Cir. 1969). Other factors that are considered in determining whether advances made by a shareholder are risk capital, or bona fide indebtedness, include undercapitalization, participation in management by one of the creditors, lack of interest charges, and identity of creditor and shareholder interest. Smyers v. Commissioner, supra at 198.

Applying the above factors to the case at hand, we find that the notes held by petitioner evidenced most of the formal attributes of indebtedness. The notes were payable on demand or at their maturity date. The notes also bore a set rate of interest.

However, when the notes are examined in light of the circumstances that surrounded their execution it is unrealistic to assume that the notes would ever be paid. Real/Tech was incorporated with an initial capital contribution of only $10,000. The corporation immediately assumed a $2.6 million debt and also immediately began to experience difficulty in generating cash flow. See Kaplan v. Commissioner, supra. Real estate sales were in a slump. Real/Tech did not have money to pay ordinary business expenses such as attorneys fees, or real estate taxes. These expenses along with current interest expenses on the $2.6 million loan were paid by petitioner. By this time it was clear that Real/Tech was in danger of imminent foreclosure on its loan by CFSL, and in fact CFSL sued for foreclosure. Matkin stated that at this time CFSL would not have loaned any more money to either petitioner or Real/Tech due to their financial difficulties.[8] CFSL began to encourage petitioner to liquidate his investment. Based upon the above analysis of Real/Tech's financial situation it is clear that it was unrealistic for petitioner to assume that he would be repaid.

Moreover, and perhaps more importantly for determining whether the indebtedness was bona fide, the parties did not in actuality enforce the obligation. Real/Tech never made any payments to petitioner of principal or interest on these notes.

After a careful consideration of all of the above factors we conclude that petitioner's advances constituted equity investments. Hollenbeck v. Commissioner, supra. While the notes contained all the formal attributes of debt none of the principal or interest was ever repaid and, due to Real/Tech's financial situation, it was unrealistic for petitioner to expect repayment. It also appears that Real/Tech was initially undercapitalized since initial capital contributions were $10,000, and indebtedness was $2.6 million. Such undercapitalization is viewed as very strong evidence that a genuine indebtedness never occurred. Tyler v. Tomlinson, 414 F.2d 844, 849 (5th Cir. 1969); Kaplan v. Commissioner, supra. Moreover, petitioner, one of Real/Tech's creditors, was also in the corporation's management operation. This fact undermines the traditional debtor/creditor relationship and makes it unlikely that the demand provisions on the notes would ever be exercised.[9] Thus, since the 25 shares of stock issued to petitioner were not issued in exchange for cancellation of true indebtedness, the stock did not qualify as section 1244 stock.

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[8] The fact that an outsider would not have made the loans in question is one factor that courts consider as evidence that purported debt was not to be repaid according to its terms. See John Town, Inc. v. Commissioner, 46 T.C. 107, 131 (1966), affd. 376 F.2d 455 (7th Cir. 1967).

As additional support for our decision, we find that the exchange herein did not serve to effectuate the congressional purpose behind section 1244. Section 1244 was enacted, as discussed previously, to encourage small business development by the infusion of new funds into small businesses. Petitioners contend that Real/Tech's issuance of the 25 shares of stock did effectuate the purpose of section 1244 because the consideration given was an investment in a continuing business. Real/Tech continued as an entity, petitioners urge, under Brei; petitioner just relinquished control. Moreover petitioners contend that the cancellation and assumption of indebtedness by petitioner was an investment for the additional reason that petitioner expected to earn a profit from the land he later purchased from Real/Tech using the option he received as part of the exchange.

We fail to find the relevance of the latter argument. We are not concerned with whether petitioner expected to make a gain on the sale of land he purchased from Real/Tech as a result of

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9/ Indeed petitioner stated at trial that he did not expect repayment of the debts he assumed for Real/Tech in 1979.

the agreement. The important factor for our purposes is the relationship of petitioner and Real/Tech at the time the Real/Tech stock was issued. Was petitioner making an investment in Real/Tech by assuming and cancelling indebtedness? We think not. When petitioner cancelled the debt owed to him by Real/Tech he was not making a new investment -- he was in fact liquidating his interest in Real/Tech. Real/Tech was insolvent at the time. He was simply attempting to change the character of his equity interest in Real/Tech by having additional shares of stock issued to him which he claimed was 1244 stock for tax purposes. A tax break was not intended by Congress to result from such a charade and it does not convert an ordinary equity interest into a section 1244 stock interest. Morgan v. Commissioner, 46 T.C. 878, 892-893 (1966).

Furthermore, petitioner's main purpose in selling Real/Tech to Brei or CU was to relieve himself as primary obligator on the mortgage note to CFSL. He received no tangible consideration for selling the 25 shares of Real/Tech stock to Brei or CU -- he simply gave it up --and retained no interest in Real/Tech.

Therefore we find that the transaction herein does not serve to effectuate the purpose of section 1244. The consideration petitioner exchanged for the stock, i.e., the advances he had made to Real/Tech, was an already existing equity interest in the issuing corporation. In such a case no new capital is being generated. Instead capital funds already committed are merely being reclassified for tax purposes resulting in no attendant infusion of capital into the corporation's financial position. Smyers v. Commissioner, supra at 196; see also Hollenbeck v. Commissioner, 422 F.2d 2 (9th Cir. 1970), affg. 50 T.C. 740 (1968). Section 1244 was designed to encourage investments in small businesses, allowing them to continue in business, not to bail out creditors by providing them with ordinary losses after the corporation has ceased doing business. See, e.g., Hill v. Commissioner, 51 T.C. 621 (1969). Congress did not intend for transactions like this one to benefit from the provisions of section 1244.[10]

Accordingly, since we have found that the advances made by petitioner constituted additional equity or risk capital and that the issuance of Real/Tech stock did not effectuate the Congressional purpose behind section 1244, we hold that the stock issued by Real/Tech was not section 1244 stock.[11] Hence, respondent's determination is sustained.

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[10] Section 1244(c) of the Code, in defining "section 1244 stock," does not itself mention cancellation of indebtedness as an acceptable consideration for section 1244 stock.

Decision will be entered under Rule 155.

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[11] See also Nelson v. Commissioner, T.C. Memo. 1984-465.

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T. C. Memo. 1986-70

UNITED STATES TAX COURT

KENNETH PORTER, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 19074-83,
36261-84.

Filed February 13, 1986.

During 1979 and 1980, P, a practicing psychiatrist, underwent psychotherapy. P deducted the costs he incurred in undergoing psychotherapy as ordinary and necessary business expenses under section 162(a), I.R.C. 1954. *Held*, because the psychotherapy improved P's skills as a psychiatrist, he is entitled to deduct the expenses he incurred in undergoing psychotherapy as an education expense under section 162(a), I.R.C. 1954. *Iglesias v. Commissioner*, 76 T.C. 1060 (1981), and *Voigt v. Commissioner*, 74 T.C. 82 (1980), applied. *Held further*, the amount of deductible telephone expenses under section 162(a), I.R.C. 1954, determined. *Held further*, P is not liable for additions to tax for fraud under section 6653(b), I.R.C. 1954. *Held further*, P is not liable for additions to tax under section 6653(a), I.R.C. 1954, for negligence or intentional disregard of rules and regulations.

ORIGINAL

William T. Holloran and Barbara T. Kaplan, for the petitioner.

Frances Ferrito Regan, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

NIMS, Judge: Respondent determined the following deficiencies in and additions to petitioner's Federal income taxes:

		Additions to Tax	
Year	Deficiency	Sec. 6653(b)[1]	Sec. 6653(a) (Alternatively)
1979	$15,929	$ 7,965	-
1980	20,278	10,139	$1,014

The issues for decision are: (1) whether petitioner, a psychiatrist, is entitled to deduct certain expenses he incurred in undergoing psychotherapy during the years in issue as ordinary and necessary business expenses under section 162(a); (2) alternatively, whether petitioner is entitled to deduct such amounts as medical expenses under section 213; (3) whether petitioner is entitled to deduct certain telephone expenses he incurred during the years in issue as ordinary and necessary business expenses under section 162(a); and (4) whether petitioner is liable for additions to tax under section 6653(b) (fraud) or, alternatively, section 6653(a) (negligence or intentional disregard of rules and regulations).

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 in effect for the years in question. All rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner Kenneth Porter (petitioner) resided in New York, New York, at the time he filed the petitions herein.

Petitioner graduated from the Albert Einstein College of Medicine in June, 1969, and subsequently received his medical license from the State of New York in 1970. In July, 1970, petitioner began a residency in psychiatry at the Albert Einstein College of Medicine. Upon completion of his residency in July, 1973, petitioner began practicing as a psychiatrist. In April, 1976, petitioner was admitted to the American Board of Psychiatry.

Petitioner was not required to undergo psychotherapy to become a psychiatrist. It was well accepted, however, that a psychiatrist who underwent psychotherapy would improve his psychotherapeutic techniques by (1) learning more about his own personality disorders so that he could separate his problems from his patient's problems and (2) modeling his own psychotherapeutic techniques after those practiced by more experienced psychiatrists. The directors of most psychiatric residency programs therefore encouraged psychiatric residents to undergo personal psychotherapy as part of their psychiatric training and to continue such therapy after the completion of their residency.

In 1965, petitioner began psychotherapy with Dr. Benjamin Rudner, a psychiatrist, for the treatment of certain personality disorders. Petitioner underwent psychotherapy with Dr. Rudner for approximately six months. After terminating his treatments with Dr. Rudner, petitioner began psychotherapy with Dr. Theodore Jacobs, another psychiatrist. Petitioner underwent psychotherapy with Dr. Jacobs for approximately nine months.

In January, 1967, while a second year medical student, petitioner began psychotherapy with Dr. Cornelius Beukenkamp (Dr. Beukenkamp), a board certified psychiatrist. Petitioner decided to undergo psychotherapy with Dr. Beukenkamp after investigating his background and learning of his excellent reputation as a psychiatrist. During the course of his investigation, petitioner discovered that Dr. Beukenkamp was (1) a board certified psychiatrist who had also received extensive training in psychoanalysis at New York Medical College; (2) the author of a book and numerous articles dealing with a wide range of psychiatric topics; (3) a member of several psychiatric associations, including the Association for Group Psychoanalysis, of which he served as president from 1957 through 1958; and (4) a participant in the 1936 Olympic Games.[2]

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[2] Petitioner testified at trial that in addition to Dr. Beukenkamp's professional qualifications, he was also interested in Dr. Beukenkamp's personal characteristics. Petitioner stated that Dr. Beukenkamp's status as an Olympic athlete reflected on "the caliber of the man."

Petitioner underwent group psychotherapy with Dr. Beukenkamp from January, 1967, through late 1970 or early 1971, when Dr. Beukenkamp left New York and settled in Costa Rica. Dr. Beukenkamp moved to Costa Rica after he developed Raynaud's disease, a disease which affects the lower extremities in cold weather. After his departure, Dr. Beukenkamp recommended to petitioner that he continue his psychotherapeutic treatment with Dr. Sidney Cohen, a psychologist in New York City. Petitioner underwent personal psychotherapy with Dr. Cohen until 1977.

In the fall of 1971, petitioner again commenced group psychotherapy with Dr. Beukenkamp. Dr. Beukenkamp conducted these sessions in person, by telephone and by audio cassette. In 1972, petitioner also began individual psychotherapy with Dr. Beukenkamp which he conducted in person, by telephone and by audio cassette. During the individual and group psychotherapy sessions, petitioner received treatment for certain personality disorders which interfered with his ability to practice as a psychiatrist. During the individual sessions, petitioner also discussed the treatment of his own patients with Dr. Beukenkamp. Petitioner patterned his psychotherapy techniques after those practiced by Dr. Beukenkamp. Petitioner underwent psychotherapy with Dr. Beukenkamp through February, 1982.

During 1979 and 1980, petitioner's group psychotherapy sessions were conducted as follows:

During April, June and September of both years, Dr. Beukenkamp traveled from Costa Rica to New York to conduct the group sessions in person. These sessions were held at the Manhattan apartment of John Bing (John), a member of the group. Dr. Beukenkamp would schedule the sessions prior to his visits to New York. Dr. Beukenkamp requested that petitioner pay for these sessions in advance.

During part of 1979, when Dr. Beukenkamp was not present in New York, he would conduct the group sessions by audio cassette. The group would meet at John's apartment to discuss their personal problems. These discussions were recorded on an audio cassette and sent to Dr. Beukenkamp in Costa Rica. After receiving and listening to the recorded session, Dr. Beukenkamp would record his psychiatric responses to the session on another cassette which he would then mail to the group in New York. The group would subsequently play Dr. Beukenkamp's tape at the beginning of the next group session.

Sometime in 1979, rather than recording his psychiatric observations on tape, Dr. Beukenkamp began to telephone the group at the beginning of each session to discuss the prior week's session. A speakerphone located in John's apartment enabled Dr. Beukenkamp and the group members to communicate with each other.

During the years in issue, petitioner also participated in individual psychotherapy sessions with Dr. Beukenkamp. During Dr. Beukenkamp's visits to New York, the sessions were held at

John's apartment. Dr. Beukenkamp scheduled these sessions prior to his arrival in New York and requested that petitioner pay for these sessions in advance.

From January, 1979, through September, 1979, when Dr. Beukenkamp was not present in New York, petitioner would record a weekly tape on which he would discuss his personal problems. Petitioner would then send this tape to Dr. Beukenkamp in Costa Rica. After receiving and listening to the tape, Dr. Beukenkamp would record his psychiatric responses on another cassette which he would then mail to petitioner in New York. Petitioner would subsequently listen to the tape.

In October, 1979, Dr. Beukenkamp decided to conduct petitioner's individual psychotherapy sessions by telephone. Petitioner therefore discontinued his use of audio cassettes and began making regular telephone calls to Dr. Beukenkamp in Costa Rica. During the course of these telephone calls, petitioner would discuss personal problems he was experiencing and Dr. Beukenkamp would provide psychiatric feedback. During 1980, petitioner made the following telephone calls to Dr. Beukenkamp in Costa Rica:[3]

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[3] The record contains itemized statements of the long distance telephone calls made by petitioner during 1980. The record, however, does not contain itemized statements of the long distance calls made by petitioner during 1979.

Date	Time	Length (min.)	Charge
1/2/80	8:01 p.m.	19	$26.60
1/9/80	8:01 p.m.	20	28.00
1/16/80	8:01 p.m.	27	37.80
1/17/80	10:05 p.m.	15	21.00
1/18/85	8:08 p.m.	13	18.20
1/23/80	8:00 p.m.	22	30.80
1/31/80	7:30 p.m.	25	35.00
2/7/80	7:30 p.m.	28	39.20
2/13/80	8:00 p.m.	30	42.00
2/21/80	7:30 p.m.	30	42.00
2/28/80	7:30 p.m.	25	35.00
3/2/80	8:29 p.m.	12	16.80
3/6/80	7:30 p.m.	27	37.80
3/13/80	7:31 p.m.	28	39.20
3/20/80	7:30 p.m.	25	35.00
3/24/80	7:35 p.m.	23	32.20
4/24/80	7:31 p.m.	28	39.20
5/1/80	8:30 p.m.	29	40.60
5/8/80	8:30 p.m.	25	35.00
5/15/80	8:30 p.m.	30	42.00
5/22/80	8:30 p.m.	29	40.60
5/29/80	8:30 p.m.	30	42.00
6/5/80	8:30 p.m.	26	36.40
6/12/80	8:30 p.m.	29	42.05
6/16/80	9:04 p.m.	26	38.60
7/17/80	8:30 p.m.	29	42.05
7/24/80	8:30 p.m.	29	42.05
7/31/80	8:30 p.m.	30	43.50
8/7/80	8:30 p.m.	29	42.05
8/14/80	8:30 p.m.	26	37.70
8/21/80	8:30 p.m.	28	40.60
8/28/80	8:29 p.m.	30	43.50
9/1/80	10:00 p.m.	30	43.50
9/4/80	8:29 p.m.	30	43.50
10/16/80	8:29 p.m.	30	43.50
10/23/80	8:29 p.m.	30	43.50
10/30/80	7:29 p.m.	30	43.50
11/6/80	7:29 p.m.	30	43.50
12/18/80	7:30 p.m.	30	43.50
12/22/80	7:30 p.m.	29	42.05
12/29/80	7:30 p.m.	29	42.05
		TOTAL	$1,553.10

During 1979, Dr. Beukenkamp charged a fee of $100 and $50 for individual and group psychotherapy, respectively. During 1980, his fee for individual and group psychotherapy was $125 and

$75, respectively. Approximately once a month, John would deliver to petitioner a small slip of paper indicating the amount he owed to Dr. Beukenkamp for individual and group psychotherapy sessions. During 1979 and 1980, petitioner issued checks payable to the order of Cornelius Beukenkamp totalling $30,349.83 and $37,100, respectively. Although Dr. Beukenkamp sometimes collected these checks in person during the months he was present in New York, John generally collected these checks on behalf of Dr. Beukenkamp. Upon receipt of a check, John would endorse it with a rubber stamp as follows:

Cornelius Beukenkamp, M.D.
John W. Bing

He would then deposit petitioner's check, together with the checks he had collected from the other group members, in his personal bank account with Chase Manhattan Bank. After depositing the checks, John would draw his own check to the order of the Chase Manhattan Bank for the total amount collected and purchase a cashier's check. John would take the cashier's check to the Bank of Boston. The Bank of Boston would then transmit funds in the amount of the cashier's check to a bank account maintained by Dr. Beukenkamp in Luxembourg.

During 1979 and 1980, petitioner maintained a diary of his daily appointments, including his individual and group psychotherapy sessions with Dr. Beukenkamp. The diaries list the following scheduled sessions:

	1979	
	Individual	Group
March 30-April 25	18	19
June 1-June 27	19	23
Sept. 7-Dec. 27	33	48
TOTAL	70	90

	1980	
	Individual	Group
Jan. 2-Jan. 31	6	17
Feb. 4-Feb. 28	4	11
March 3-March 31	6	15
April 1-April 30	15	22
May 1-May 29	5	13
June 2-June 30	11	18
July 1-July 31	12	20
Aug. 4-Aug. 28	4	5
Sept. 1-Sept. 30	17	22
Oct. 1-Oct. 30	11	21
Nov. 3-Nov. 27	4	11
Dec. 1-Dec. 30	5	14
TOTAL	100	189

During 1979 and 1980, petitioner maintained a private psychiatric practice and served as Director of Group and Family Therapy at St. Luke's Hospital. In his private practice, petitioner spent approximately 40 to 50 hours per week conducting individual and group psychotherapy. At St. Luke's Hospital, he spent an additional 30 hours per week conducting psychotherapy and teaching psychotherapy techniques to psychiatric residents and psychology students.

On Schedules C attached to his 1979 and 1980 Federal income tax returns, petitioner claimed psychotherapy expenses of $29,224 and $38,120, respectively, as professional education and development expenses. He also claimed telephone expenses in the amounts of $1,643 and $2,429 for 1979 and 1980, respectively. In the notices of deficiency, respondent disallowed these deductions in full. The notices also contained additions to tax under section 6653(b) (fraud) or, alternatively, section 6653(a) (negligence or intentional disregard of rules and regulations).

OPINION

Issue 1. Psychotherapy Expenses

The first issue for decision is whether petitioner is entitled to deduct certain expenses he incurred in undergoing psychotherapy during the years in issue as ordinary and necessary business expenses under section 162(a). Under section 162 education expenses are deductible as ordinary and necessary business expenses when the education maintains or improves skills required by an individual in his trade or business. Section 1.162-5(a)(1), Income Tax Regs. Such expenses are not deductible, however, if the education is undertaken either to meet the minimum requirements for that trade or business or to qualify for a new trade or business. Section 1.162-5(b)(2) and (3), Income Tax Regs.

Petitioner contends that during 1979 and 1980 he incurred expenses in the amounts of $29,224 and $38,120, respectively, in undergoing psychotherapy with Dr. Beukenkamp. He further contends that because the psychotherapy improved his skills as a psychiatrist, such expenses are deductible as education expenses under section 162(a). Respondent does not challenge petitioner's claimed deductions on the grounds that the psychotherapy qualified petitioner for a new profession or satisfied minimum requirements of his present profession. Rather, respondent argues that petitioner has failed to establish that the above amounts were incurred and paid for psychotherapy or that such amounts were received by Dr. Beukenkamp. Respondent alternatively contends that petitioner has not established that he incurred expenses in excess of $13,000 and $26,875 in undergoing psychotherapy during 1979 and 1980, respectively.[4] Respondent further argues that even if petitioner has established that he paid some amount to Dr. Beukenkamp for so-called "psychotherapy," Dr. Beukenkamp's methods were not therapeutic and therefore did not improve his skills as a psychiatrist. We will first consider the amount of expenses, if any, petitioner incurred in undergoing psychotherapy with Dr. Beukenkamp during 1979 and 1980.

To support his claimed deductions, petitioner presented cancelled checks payable to the order of Cornelius Beukenkamp totalling $30,349.83 and $37,100 for 1979 and 1980, respectively. On the record before us, we are satisfied that Dr. Beukenkamp

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[4] Respondent determined these amounts as follows:

1979	
85 individual sessions @ $100 per session	$ 8,500
90 group sessions @ $50 per session	4,500
TOTAL	$13,000

1980	
101 individual sessions @ $125 per session	$12,625
190 groups sessions @ $75 per session	14,250
TOTAL	$26,875

actually received these amounts. We recognize that Dr. Beukenkamp's method of billing for his services and his arrangements for receiving payments are sufficiently unconventional so as to raise questions as to Dr. Beukenkamp's motives. These arrangements are described in our findings of fact and need not be repeated here. Dr. Beukenkamp did not testify at trial. Nevertheless, it is not Dr. Beukenkamp's tax affairs which are under scrutiny in this case, but petitioner's, and we have no basis upon which to hold petitioner responsible for Dr. Beukenkamp's arrangements or reason to do so.

Petitioner, however, has failed to establish that Dr. Beukenkamp received payments in excess of $13,000 and $27,175 during 1979 and 1980, respectively, for his performance of psychotherapy. At trial, petitioner presented diaries he maintained during 1979 and 1980 which contain a list of his daily appointments for those years. Petitioner's diary for 1979 establishes that he participated in 70 individual psychotherapy sessions and 90 group psychotherapy sessions with Dr. Beukenkamp during that year. Similarly, petitioner's diary for 1980 establishes that he participated in 100 private psychotherapy sessions and 189 group psychotherapy sessions with Dr. Beukenkamp during that year.

Petitioner also presented 15 audio cassettes containing psychiatric comments recorded by Dr. Beukenkamp during 1979. These tapes represent private psychotherapy sessions which petitioner participated in during 1979 but which do not appear in his 1979 diary of appointments. The record also contains copies of petitioner's itemized telephone bills for 1980 which show that he engaged in four private psychotherapy sessions by telephone which do not appear in his 1980 diary of appointments. Thus, based on the records presented at trial, we find that petitioner has established that he participated in 85 individual psychotherapy sessions and 90 group psychotherapy sessions during 1979. We further find that petitioner has established that he participated in 104 individual psychotherapy sessions and 189 group psychotherapy sessions during 1980.

Petitioner testified at trial that Dr. Beukenkamp charged a fee of $50 per group session and $100 per private session during 1979. Petitioner further testified that Dr. Beukenkamp charged a fee of $75 per group session and $125 per private session during 1980. We found petitioner's testimony to be credible and unimpeached. Consequently, we find that petitioner incurred and paid the following expenses in undergoing psychotherapy with Dr. Beukenkamp during 1979 and 1980:

1979

85 individual sessions @ $100 per session	$ 8,500
90 group sessions @ $50 per session	4,500
TOTAL	$13,000

1980

104 individual sessions @ $125 per session	$13,000
189 group sessions @ $75 per session	14,175
TOTAL	$27,175

Having determined the amount of expenses petitioner incurred in undergoing psychotherapy with Dr. Beukenkamp during the years in issue, we must next determine the amount of the expenses, if any, which constitutes an ordinary and necessary business expense within the meaning of section 162(a). Petitioner maintains that because the psychotherapy improved his skills as a psychiatrist, all of the expenses he incurred in undergoing psychotherapy are deductible as education expenses under section 162(a). Respondent disagrees, primarily arguing that petitioner's sessions with Dr. Beukenkamp were not therapeutic and therefore did not improve his skills as a psychiatrist.

To support his position, petitioner relies on Voigt v. Commissioner, 74 T.C. 82 (1980), and Iglesias v. Commissioner, 76 T.C. 1060 (1981). In Voigt, we held that a clinical social worker who practiced psychotherapy was entitled to deduct the costs she incurred in undergoing psychoanalysis because the psychoanalysis improved her skills as a social worker. In so holding, we found an integral relationship between the education involved and her employment, stating that:

> A deeper self-understanding * * * contributes directly to an improvement in a therapist's diagnostic skills; a clinical social worker must be able to separate her personality problems from those of her patients so that she can properly diagnose and treat her patients' problems. [74 T.C. at 87.]

Similarly, in Iglesias v. Commissioner, 76 T.C. 1060 (1981), we held that a second year resident in a residency program in psychiatry was entitled to deduct the costs he incurred in undergoing psychoanalysis under section 162(a). In Iglesias, we found that "psychoanalysis maintained or improved the skills required by [taxpayer] in his employment as a licensed physician treating psychiatric patients." 76 T.C. at 1064.

In the instant case, the record clearly establishes that psychotherapy improved petitioner's ability to practice as a psychiatrist. We therefore think that the above cases are dispositive of the issue presented herein. During the years in issue, petitioner was a practicing psychiatrist who conducted both group and individual psychotherapy sessions. During this same period of time, petitioner was undergoing psychotherapy with Dr. Beukenkamp for the treatment of a number of personality disorders which interfered with his ability to practice as a psychiatrist. Petitioner testified at trial that as a result of his psychotherapy with Dr. Beukenkamp he had reduced the severity of his personality disorders and, therefore, had improved his skills as a psychotherapist. He further testified that he modeled his own therapy techniques after those used by Dr. Beukenkamp and often discussed the treatment of his own patients with Dr. Beukenkamp during his sessions with Dr. Beukenkamp.

Moreover, petitioner's expert witness, Dr. Harold Schwartz, a psychiatrist certified by the American Board of Psychiatry and Neurology, agreed that petitioner's psychotherapy treatments had improved his skills as a psychiatrist. Dr. Schwartz based his opinion on discussions he had with petitioner concerning petitioner's personality disorders and Dr. Beukenkamp's treatment of those personality disorders. Dr. Schwartz further testified that psychotherapy is important to the development and training of all psychiatrists because it helps them to clear away psychological blind spots that obscure their ability to see and understand their patients' problems.

Respondent nevertheless contends that the facts of this case are distinguishable from the facts in Voigt and Iglesias in that Dr. Beukenkamp's psychotherapy methods were not therapeutic. To support his position respondent presented the testimony of Dr. Stanley L. Portnow, a board certified psychiatrist and psychoanalyst. At trial, Dr. Portnow challenged the therapeutic value of Dr. Beukenkamp's psychotherapy methods on the ground that most of the therapy sessions in issue were conducted by telephone and by audio cassette. Dr. Portnow testified that in the absence of an emergency he was not aware of any school of thought that allows a psychiatrist to conduct psychotherapy by telephone. He also testified that he was not aware of any situation in which the use of an audio cassette was acceptable. Moreover, after listening to several tapes containing Dr.

Beukenkamp's recorded comments, Dr. Portnow concluded that petitioner had not, in fact, undergone psychotherapy with Dr. Beukenkamp.

Although we recognize that Dr. Portnow is sufficiently qualified to testify as an expert in psychiatry, the record contains substantial evidence that Dr. Beukenkamp's psychotherapy methods were indeed therapeutic. Dr. Schwartz, petitioner's expert witness, testified that the use of the telephone in psychotherapy, although not common, is an acceptable practice when the therapist or patient moves to a new location. Dr. Schwartz referred at trial to several published materials which support his conclusion. Moreover, after listening to Dr. Beukenkamp's taped psychiatric comments and talking with petitioner, Dr. Schwartz concluded that the private and group psychotherapy sessions which were conducted by tape had the key elements of psychotherapy; i.e., systematic identification and discussion of petitioner's personality disorders.

Further, the record clearly establishes that petitioner, who is also a practicing psychiatrist, found Dr. Beukenkamp's psychotherapy methods effective in the treatment of his personality disorders. At trial, petitioner described the effectiveness of Dr. Beukenkamp's therapy as follows:

> The treatment with Dr. Beukenkamp was enormously helpful to me, it was helping me get over all my personal problems, it was teaching me a tremendous amount about how to conduct psychotherapy myself. I was very satisfied with the treatment. I couldn't imagine finding anyone who would be as helpful for me personally or professionally.

Petitioner's willingness to undergo psychotherapy with Dr. Beukenkamp for approximately 11 years supports this testimony. We do not think that petitioner would have continued his relationship with Dr. Beukenkamp for this period of time if he did not find Dr. Beukenkamp's methods to be effective.

Moreover, petitioner was willing to pay more than $40,000 to Dr. Beukenkamp during 1979 and 1980 for his psychiatric services. By 1979, petitioner had undergone psychotherapy with Dr. Beukenkamp for at least eight years and, therefore, was well aware of Dr. Beukenkamp's psychotherapy methods and the effectiveness of those methods. Thus, petitioner's willingness to pay these amounts to Dr. Beukenkamp for his psychiatric services is additional evidence of the effectiveness of Dr. Beukenkamp's methods.

Additionally, some of the members of petitioner's therapy group testified at trial that they had incurred expenses in amounts similar to those incurred by petitioner in undergoing psychotherapy with Dr. Beukenkamp. We therefore assume that they also found Dr. Beukenkamp's psychotherapy methods to be effective.

Thus, in the absence of additional evidence challenging the effectiveness of Dr. Beukenkamp's psychotherapy methods, we find that Dr. Portnow's testimony is insufficient to overcome the substantial evidence in the record that Dr. Beukenkamp's methods were indeed therapeutic.

We are also unpersuaded by respondent's attempt to distinguish Voigt and Iglesias on the ground that the taxpayers in those cases underwent psychoanalysis while, here, petitioner underwent psychotherapy. At trial, Dr. Schwartz explained that psychoanalysis is only one of many types of psychotherapy used in the treatment of a psychiatrist. We therefore do not think that petitioner's decision to participate in a form of psychotherapy other than psychoanalysis should be determinative.

Respondent also argues that although petitioner's personality disorders might have interfered with his ability to practice as a psychiatrist, petitioner's primary purpose in undergoing psychotherapy was to improve his personal relationships. Respondent therefore concludes that petitioner's psychotherapy expenses are non-deductible personal expenses. We disagree.

We initially note that the record establishes that during the years in issue petitioner underwent psychotherapy for the treatment of certain personality disorders which interfered with his ability to practice psychiatry. The record, however, does not disclose whether petitioner's primary reason for undergoing psychotherapy during 1979 and 1980 was to improve his ability to practice as a psychiatrist or to improve his personal relationships. Nevertheless, under the appropriate regulations, petitioner's subjective intent is irrelevant. Prior to 1968, section 1.162-5(a)(1), Income Tax Regs., allowed a deduction for "education * * * undertaken primarily for the purpose of maintaining or improving skills required by the taxpayer in his * * * trade or business." The present regulations, however, allow a deduction for education that "[m]aintains or improves skills required by the individual in his employment or other trade or business." Section 1.162-5(a)(1), Income Tax Regs. Thus, the present regulations apply an objective standard (i.e., whether the education improved petitioner's skills) rather than a subjective standard (i.e., whether petitioner undertook the education primarily to improve his skills). Petitioner's primary reason for undergoing psychotherapy is therefore not determinative of the issue.

Finally, respondent argues that the amount of expenses petitioner incurred in undergoing psychotherapy during the years in issue was not reasonable. Respondent further argues that petitioner has not established the portion of the expenses which would be reasonable. Respondent therefore concludes that the entire deduction should be disallowed. We, however, do not think that petitioner incurred an unreasonable amount of expenses in undergoing psychotherapy during the years in issue.

Petitioner testified that during 1979 he paid Dr. Beukenkamp $50 per group psychotherapy session and $100 per individual psychotherapy session. He further testified that during 1980 he paid Dr. Beukenkamp $75 per group session and $125 per individual session. At trial, petitioner's expert, Dr. Schwartz, testified that Dr. Beukenkamp's fee schedule was not unreasonable. On the other hand, respondent's expert, Dr. Portnow, stated that Dr. Beukenkamp's fee schedule was unreasonable. Both experts agreed, however, that New York psychiatrists charged various fees for their psychiatric services. Dr. Portnow further agreed that during 1979 at least one New York psychiatrist charged a fee of $150 per individual psychotherapy session. He also stated that a psychiatrist's fee for group therapy is generally equal to one-half of the amount he or she charges for individual therapy.

In the instant case, because the fees charged by Dr. Beukenkamp during the years in issue did not exceed $150 per individual session or $75 per group session, we refuse to find that the amount of expenses petitioner incurred in undergoing psychotherapy was unreasonable. The record clearly establishes that Dr. Beukenkamp was a highly respected psychiatrist and psychoanalyst with more than 30 years of psychiatric experience. He was also the author of a book and numerous articles dealing with a wide range of psychiatric topics as well as a member of several prestigious psychiatric associations. The record further establishes that Dr. Beukenkamp effectively treated petitioner's personality disorders. Indeed, petitioner testified that he "couldn't imagine finding anyone who would be as helpful for me personally or professionally." Thus, although we recognize that Dr. Beukenkamp's fees were somewhat high, we do not find it unreasonable that he would charge a premium for his services in light of his years of experience, his psychiatric expertise and his excellent reputation. We therefore do not believe that the amount of expenses petitioner incurred in undergoing psychotherapy during the years in issue was unreasonable.

In conclusion, we are satisfied that Dr. Beukenkamp's psychotherapy methods effectively treated petitioner's personality disorders and, therefore, improved petitioner's ability to practice as a psychiatrist. We are also satisfied that the amount of expenses petitioner incurred in undergoing psychotherapy was not unreasonable. Thus, based on the record before us and relying on Voigt v. Commissioner, supra, and Iglesias v. Commissioner, supra, we find that petitioner is entitled to deduct psychotherapy expenses of $13,000 and $27,175 in 1979 and 1980, respectively, as ordinary and necessary business expenses under section 162(a). We therefore need not consider petitioner's alternative argument that such expenses are deductible as medical expenses under section 213.

Issue 2. Telephone Expenses

The next issue for decision is the amount of telephone expenses, if any, petitioner is entitled to deduct as an ordinary and necessary business expense under section 162(a). At trial, petitioner testified that during the years in issue he maintained two telephones in his apartment, one for business use and one for personal use. Petitioner contends that because he only used the business telephone to speak with his patients and to receive treatment from Dr. Beukenkamp, he is entitled to deduct all of the expenses he incurred in connection with the use of his business telephone under section 162(a). Respondent contends that petitioner has not substantiated his business use of the telephone. Respondent's determination is presumtively correct, and petitioner bears the burden of proving error in this determination. Rule 142(a).

To substantiate his business use of the telephone, petitioner presented at trial (1) copies of monthly bills he received during 1979 and 1980 for his use of the business telephone, (2) cancelled checks showing payment of those bills and (3) statements itemizing each long distance telephone call he made from the business telephone during 1980. These itemized statements establish that petitioner incurred expenses of $1,553.10 in calling Dr. Beukenkamp in Costa Rica during 1980. Petitioner testified at trial that he underwent psychotherapy with Dr. Beukenkamp during these calls. The regularity of the date and time of these calls and the uniformity of their length corroborate petitioner's testimony. We therefore find that petitioner incurred telephone expenses of $1,553.10 in undergoing psychotherapy with Dr. Beukenkamp during 1980. Consequently, because the psychotherapy improved petitioner's skills as a psychiatrist, he is entitled to deduct the telephone expenses he incurred in undergoing psychotherapy as an ordinary and necessary business expense under section 162(a).

Petitioner did not present any records establishing the amount of telephone expenses he incurred in connection with the treatment of his patients during 1980. Nevertheless, based on petitioner's testimony we are satisfied that he incurred some telephone expenses in connection with the treatment of his patients. Making "as close an approximation as [we] can, bearing heavily if [we] choose upon the taxpayer whose inexactitude is of his own making," Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930), we find that petitioner incurred 50 percent of the remaining telephone expenses he claimed on his 1980 return in connection with the treatment of his patients. Consequently, we hold that petitioner is entitled to deduct telephone expenses of $437.95 in connection with the treatment of his patients during 1980.

Although petitioner presented copies of his monthly telephone bills for 1979, he did not present itemized statements of the long distance telephone calls he made during that year. Thus, we are unable to determine from the records presented at trial the amount of telephone expenses petitioner incurred in undergoing psychotherapy during 1979. Petitioner testified, however, that from October, 1979, through December, 1979, he telephoned Dr. Beukenkamp in Costa Rica approximately once a week. Although petitioner presented no evidence of the expenses he incurred in making these telephone calls, the record establishes that during 1980 petitioner paid an average of $37.88 per telephone call he made to Dr. Beukenkamp in Costa Rica. Thus, based on petitioner's testimony and relying on *Cohan v. Commissioner*, *supra*, we find that he made 12 telephone calls to Dr. Beukenkamp in Costa Rica during 1979 at a cost of $37.88 per telephone call. We therefore hold that petitioner incurred deductible telephone expenses of $454.56 in undergoing psychotherapy with Dr. Beukenkamp during 1979.

Similarly, petitioner presented no records of the amount of telephone expenses he incurred during 1979 in connection with the treatment of his patients. As stated above, however, based on petitioner's testimony, we are satisfied that he incurred some telephone expenses in connection with the treatment of his patients. Thus, relying on *Cohan v. Commissioner*, *supra*, we find that petitioner incurred 50 percent of the remaining telephone expenses he claimed on his 1979 return in connection with the treatment of his patients. Consequently, we hold that petitioner is entitled to deduct telephone expenses of $594.22 in connection with the treatment of his patients during 1979.

Issue 3. Additions to Tax for Fraud

The next issue for decision is whether petitioner is liable for additions to tax for fraud under section 6653(b). Respondent contends that the record establishes that petitioner took an affirmative role in a complex scheme to avoid taxation. We disagree.

Fraud is defined as an intentional wrongdoing designed to evade tax believed to be owing. Professional Services v. Commissioner, 79 T.C. 888, 930 (1982). Respondent bears the burden of proving fraud by clear and convincing evidence. Miller v. Commissioner, 51 T.C. 915 (1969); section 7454(a); Rule 142(b). Although respondent may meet this burden with circumstancial evidence, Stephenson v. Commissioner, 79 T.C. 995, 1005, 1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984), fraud cannot be inferred from a mere inadvertent understatement of income, Holland v. United States, 348 U.S. 121, 137 (1954), or from a deficiency in taxes due to an honest mistake or poor judgment. Iley v. Commissioner, 19 T.C. 631, 635 (1952).

The evidence in this case clearly establishes that petitioner incurred substantial expenses in undergoing psychotherapy with Dr. Beukenkamp during the years in issue. Moreover, we have found that Dr. Beukenkamp's psychotherapy methods were effective and improved petitioner's skills as a psychiatrist. Although we have also found that petitioner's records are insufficient to substantiate the entire amount of his claimed expenses, this finding, standing alone, is not clear and convincing evidence that petitioner intentionally overstated his deductions to avoid a tax he believed to be owing. Valetti v. Commissioner, 260 F.2d 185, 188 (3rd Cir. 1958), affg. in part and revg. in part 28 T.C. 692 (1957). Consequently, on the record before us, we find that respondent has not established fraud by clear and convincing evidence, and therefore, petitioner is not liable for additions to tax for fraud under section 6653(b).

Issue 4. Additions to Tax under Section 6653(a)

The final issue for decision is whether petitioner is liable for additions to tax under section 6653(a) for negligence or intentional disregard of rules and regulations. In the notice of deficiency respondent determined alternatively that petitioner was liable for additions to tax under section 6653(a) for taxable year 1980. Respondent contends that petitioner's failure to keep adequate records of his psychotherapy expenses support this determination. We, however, think that petitioner maintained sufficient records of the expenses he incurred in undergoing psychotherapy during 1980 to avoid additions to tax under section 6653(a).

Petitioner presented at trial cancelled checks payable to Dr. Beukenkamp in sufficient amounts to support the deductions he claimed on his 1979 and 1980 Federal income tax returns. Although we have found that these checks, standing alone, are insufficient to substantiate the entire amount of the claimed deductions, we have allowed a substantial portion of the claimed deductions based on these checks and diaries of appointments petitioner maintained during 1979 and 1980. The mere fact that we do not consider petitioner's records adequate to substantiate all of the deductions he claimed during the years in issue does not require us to find that petitioner's underpayment of tax was due to negligence or intentional disregard of respondent's rules and regulations. Robinson v. Commissioner, 51 T.C. 520, 542 (1968), mod. per curiam 422 F.2d 873 (9th Cir. 1970). We therefore hold that petitioner is not liable for the additions to tax for negligence provided in section 6653(a).

To reflect the foregoing,

Decisions will be entered under Rule 155.

742-B Ju 11.7/2: 1986-71

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T. C. Memo. 1986-71

UNITED STATES TAX COURT

HENRY J. CURRIE AND BARBARA J. CURRIE, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 8240-84,
8241-84.
Filed February 18, 1986.

John Kennedy Lynch, for the petitioners.

Susan M. Gray, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PAJAK, Special Trial Judge: These consolidated cases were assigned pursuant to the provisions of section 7456(d) and Rules 180, et seq.[1]

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[1] All section references are to the Internal Revenue Code of 1954 as in effect during the taxable year in issue, unless indicated otherwise. All rule references are to the Tax Court Rules of Practice and Procedure.

Respondent determined deficiencies in petitioners' 1980 Federal income taxes as follows:

Docket No.	Deficiencies	Addition to Tax Sec. 6653(a)
Henry J. Currie D.N. 8240-84	$2,926.30	- 0 -
Barbara J. Currie D.N. 8241-84	$ 888.00	$44.40

After concessions by petitioners, the only issue remaining for decision is whether petitioners are entitled to file a joint return under section 6013.

To the extent stipulated, the facts are so found.

Petitioners resided in Cleveland, Ohio, at the time they filed their respective petitions.

At all relevant times, petitioners were married to each other. Nevertheless, each petitioner filed a separate return for 1980. Petitioner Henry J. Currie (Henry) indicated his filing status as "single." Petitioner Barbara J. Currie indicated her filing status as "married filing separate return."

Respondent made various adjustments in the separate notices of deficiencies mailed to each of the petitioners. Respondent also determined that Henry was not entitled to file his return under the single status and used the rates applicable to married persons filing separately.

Petitioners have conceded all of the adjustments and the addition to tax made by respondent in the notices of deficiencies, except that they claim that they are entitled to file a joint income tax return with the tax rates applicable to married persons filing jointly. They base this claim on the assertion that they filed their amended joint return before filing their petitions. Respondent contends that even if their assertion is correct, petitioners are foreclosed from filing a joint return by section 6013(b)(2)(C).

On December 30, 1983, respondent mailed separate notices of deficiencies to petitioners. On March 29, 1984, petitioners filed their respective petitions with the Court, together with an executed copy of a Form 1040X which is alleged to be a copy of an amended joint return.

The copies of a Form 1040X (amended joint return) attached to petitioners' petitions were dated "3/19/84." The copy of the Form 1040X received in evidence was dated "3-22-84." The check which purportedly accompanied a Form 1040X was dated "March 25, 1984." Respondent has no record of the filing of a Form 1040X. When respondent inquired by letter about the nature of the March 25, 1984 check, counsel for petitioners responded on the back page of that letter with the notation that it related to a "1040X" for 1980 which was filed "3-25-84." At best, petitioners' evidence showed that they filed an amended joint return with the Internal Revenue Service after the notices of deficiency were issued. Even if we accepted petitioners' position, that is not enough.

Under section 6013(b)(1), a husband and wife who have filed separate returns may subsequently elect to file a joint return under certain conditions. Under section 6013(b)(2)(C), such election can not be made "after there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 6212, if the spouse, as to such notice, files a petition with the Tax Court within the time prescribed in section 6213." In brief, a married taxpayer who has not filed a joint return before a notice of deficiency was issued to that taxpayer cannot elect to file a joint return if that taxpayer timely petitions the Tax Court. Jacobson v. Commissioner, 73 T.C. 610, 614 (1979).

Under the clear language of the statute, the right of each petitioner to elect to file a joint return after having first filed separate returns was terminated after respondent mailed a notice of deficiency to a spouse and that spouse timely filed a petition with the Tax Court with respect to the taxable year in issue. Section 6013(b)(2)(C); Druker v. Commissioner, 77 T.C. 867, 873 (1981), affd. on this issue 697 F.2d 46 (2d Cir. 1982). The statutory language is clear and unambiguous. This Court has no authority to expand the explicit terminology of the statute. Donigan v. Commissioner, 68 T.C. 632 (1977). We must apply the law as written. On this record, we must sustain respondent's determinations.

Decisions will be entered

for the respondent.

742-B
Ju11.7/2:1986-72
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T. C. Memo. 1986-72

UNITED STATES TAX COURT

GERALDINE G. HALL, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2307-85. Filed February 18, 1986.

Geraldine G. Hall, pro se.

Jose A. Bonau, for the respondent.

MEMORANDUM OPINION

COUVILLION, Special Trial Judge: This case was assigned pursuant to the provisions of section 7456(d) of the Code[1] and Rule 180.

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated and all Rule references are to the Tax Court Rules of Practice and Procedure.

Respondent determined a deficiency in petitioner's Federal income tax for the year 1982 in the amount of $341. The sole issue for decision is whether petitioner is entitled to a deduction for two-earner married couples when she was married but filed a separate return.

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner resided in Baton Rouge, Louisiana, at the time the petition herein was filed. Petitioner was married to Claudius Hall at all times pertinent to this proceeding.

Petitioner filed a timely Federal income tax return for 1982 as a married individual filing separately. On her return, petitioner claimed a "[d]eduction for a married couple when both work" in the amount of $987.16. Respondent disallowed the deduction, asserting that the deduction is only available to married individuals who file a joint return as required by section 221. We agree with respondent.

Section 221 was enacted by Congress in order to alleviate the so-called "marriage penalty." This penalty results from the fact that generally current tax schedules provide higher rates of tax for married individuals filing separate or joint returns than for single taxpayers.

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Subject to certain limitations, section 221 provides a deduction from gross income for two-earner married couples equal to ten percent of the lower earner's earned income. Congress, in enacting section 221, limited the scope of section 221 to joint returns. Section 221(a)(1) provides, in relevant part:

> (1) In General.--In the case of a joint return under section 6013 for the taxable year, there shall be allowed as a deduction an amount equal to 10 percent of the lesser of--
>
> (A) $30,000, or
>
> (B) the qualified earned income of the spouse with the lower qualified earned income for such taxable year. [Emphasis supplied.][2]

Section 6013 provides, in relevant part: "A husband and wife may make a single return jointly of income taxes * * *."

Finally, Senate Report No. 97-144 (1981), relating to section 221 provides "[w]ith certain exceptions, two-earner married couples who file a joint return will be allowed a deduction from gross income in arriving at adjusted gross income." (Emphasis supplied.) 1981-2 C.B. 412, 417. The language in section 221 and the Committee report is clear and unambiguous. Congress chose to limit the utilization of this deduction to married individuals filing a joint return. Petitioner did not file a joint return, therefore, respondent's determination is sustained.

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[2] For the year 1982, section 221(a)(2) provided that the deduction is five percent instead of ten percent.

Petitioner, in her petition, asserts: "The I.R.S. is arbitrarily and discriminatorily interpreting and applying the laws so as to deny petitioner due process and equal protection of the law and the protection of the other constitutional provisions that she is entitled to as a citizen of the United States of America."

Petitioner, in her testimony, argued the tax rate schedules which cause the marriage penalty are unfair.

This Court has treated the issue of whether the marriage penalty is constitutional in *Druker v. Commissioner*, 77 T.C. 867 (1981), affd. on this issue 697 F.2d 46 (2d Cir. 1982). In *Druker*, we rejected the taxpayer's claim that the rate schedules and other provisions which make up the marriage penalty are unconstitutional.

With respect to petitioner's claim of arbitrary and discriminatory conduct by the Internal Revenue Service, the notice of deficiency is presumed to be correct, and petitioner has the burden of establishing error therein, including claims of arbitrary and discriminatory conduct by respondent. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); Rule 142. Petitioner presented no evidence to establish her claim, and we find her assertions wholly without merit. Whether or not the marriage penalty is unfair is an issue this Court cannot address. That question must be answered by Congress.

Decision will be entered
for the respondent.

742-B

Ju 11.7/2:1986-73

COMPLETED

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T. C. Memo. 1986-73

UNITED STATES TAX COURT

ESTATE OF WILLIAM C. BETTENHAUSEN, DECEASED
ELIZABETH D. BETTENHAUSEN, EXECUTOR, Petitioner
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24133-82. Filed February 18, 1986.

B. R. Tongren, for the petitioner.

David D. Baier, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARR, Judge:[*] Respondent determined a deficiency in petitioner's estate tax of $89,712.42. After concessions by both sides, the sole issue for decision is whether the executor of an estate, who in all other respects has made a valid election to specially value real property under section 2032A,[1] is deprived of the benefit of that statute because noninheriting cotenants of the decedent never agreed to the application of section 2032A(c).

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[*] By order of the Chief Judge, this case was reassigned from Judge Charles R. Simpson to Judge Carolyn Miller Parr.

FINDINGS OF FACT

The facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioner Elizabeth D. Bettenhausen ("petitioner") is the executor of the estate of her deceased husband, William C. Bettenhausen ("decedent"). Petitioner resided in Peotone, Ill., at the time of the filing of the petition herein. The return for the Federal estate tax of the Estate of William C. Bettenhausen was filed with the Internal Revenue Service at Kansas City, Mo.

Decedent died on November 18, 1979. At the time of his death, he owned undivided one-third interests in five parcels of farm land comprising approximately 678 acres. Each of decedent's brothers, Earl and Wesley Bettenhausen, likewise owned an undivided one-third interest in each of the five parcels. The decedent devised his undivided one-third interests in the farm land to his surviving spouse and children.

Decedent's estate tax return was filed on August 15, 1980. At that time, petitioner, in determining the value of decedent's gross estate, chose to value under section 2032A the decedent's interests in the subject farm land. That statute allows a special valuation for real property of the type involved here.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954, as amended and in effect at the date of decedent's death.

To comply with section 2032A, petitioner endeavored to obtain the signatures of decedent's brothers on a written agreement entitled "IRC Section 2032A Agreement." This agreement, in which the signatories consent to the contingent imposition of an additional estate tax, described the property for which an election was being attempted as "an undivided one-third interest in farm property" identified as the five parcels comprising the entire 678 acres of farm land. The decedent's brothers refused to execute the section 2032A(d)(2) agreement. The agreement, therefore, was signed only by decedent's widow and all four of his children.

With the return and agreement described above, a document was filed entitled "Election of Special Use Valuation as Authorized by Section 2032A of the Internal Revenue Code." In the election, the fair market value of decedent's one-third interests was declared to be $707,667 and the special use valuation under section 2032A was declared to be $166,268. The fair market value figure was supported by an appraisal report prepared by John H. Weitendorf, a Joliet, Ill., Realtor-Appraiser.

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On March 31, 1981 petitioner filed suit in the Circuit Court of Will County, Illinois to partition the 678 acres. In July of 1981, in settlement of that suit, petitioner acquired a fee simple interest in two of the five parcels which comprised the 678 acres. These two parcels totaled 273 acres.

On August 3, 1981, petitioner filed an amended estate tax return and again sought to elect special use valuation under section 2032A for the realty then owned in fee by decedent's estate. This return also was filed with an election and an agreement, documents similar to the ones described above as having been filed with the original return. These documents differed from the ones filed previously in that the property descriptions contained therein described the two parcels received in settlement of the partition suit, not the undivided one-third interests in the five parcels totaling 678 acres.[2]

On August 23, 1982, respondent mailed petitioner a statutory notice of deficiency. This notice increased the value of the real estate component of decedent's gross estate by $541,399, representing the difference between the fair market valuation and special use valuation figures. After adjustments, respondent determined a deficiency of $89,712.41 in the estate tax liability as computed by petitioner.

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[2] We note that on the amended return, petitioner took cognizance of the sec. 2032A(a)(2) $500,000 limit on the amount by which the special use valuation could decrease the gross estate, added to the special valuation figure the amount by which the decrease in the gross estate attributable to sec. 2032A exceeded $500,000 and adjusted the real estate component of the gross estate figure on the amended return accordingly.

OPINION

To determine the value of a decedent's gross estate, the value of property includable therein is normally determined by valuing the property at its highest and best use. See Estate of Cowser v. Commissioner, 736 F.2d 1168, 1170 (7th Cir. 1984), affg. 80 T.C. 783 (1983). Alternatively, section 2032A allows a decedent's executor to value inherited "qualified real property" (as that term is defined in section 2032A(b))[3] on the basis of the property's actual use at the time of decedent's death. See Estate of Cowser v. Commissioner, supra; Martin v. Commissioner, 84 T.C. 620, 625-629 (1985). One requirement for taking advantage of such alternate valuation is that the executor must file the agreement described in section 2032A(d)(2). Sec. 2032A(a)(1)(B). Section 2032A(d)(2) provides:

> (2) Agreement.--The agreement referred to in this paragraph is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (c) with respect to such property.

Section 2032A(c) provides that if, within a prescribed period of time, any interest in the alternatively valued "qualified real property" is disposed of by a "qualified heir"

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[3] Respondent concedes that the farm land in question was qualified real property in all respects, except he objects that no valid agreement, as described in the text, was filed.

(as that term is defined in section 2032A(e)(i)) to a nonfamily member or such heir ceases to use such property for a "qualified use" (as that term is defined in section 2032A(b)(2)), there will be imposed an additional estate tax. Section 6324B(a) secures that additional tax by imposing a statutory lien with the following language:

> (a) General Rule.--In the case of any interest in qualified real property (within the meaning of section 2032A(b)), an amount equal to the adjusted tax difference attributable to such interest (within the meaning of section 2032A(c)(2)(B)) shall be a lien in favor of the United States on the property in which such interest exists.

The legislative history to section 2032A reflects a recognition by Congress that to pay an estate tax liability based on a highest and best use valuation of family farm or business real property, heirs may have to terminate use of the property as a family farm or business. See Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 536-537 (1976), 1976-3 C.B. (Vol. 2) 548-549 (hereinafter "Joint Comm. Rept."). Congress thought it desirable, however, to encourage the use of property for family farms and other business purposes. Joint Comm. Rept., supra at 536-37.

Congress also realized that section 2032A would allow for a windfall if the alternate valuation was used and the property was soon sold or ceased to be utilized in the manner which allowed for the alternate valuation. Joint Comm. Rept., supra at 537.

Hence, the additional estate tax recapture and lien described above were provided for in sections 2032A(c) and 6324(B), respectively. However,

> [t]he Congress believed that each person receiving an interest subject to potential recapture should agree to this potential liability, especially since that person may not have received the tax benefits from the special use valuation (because, for example, the estate tax burden is borne by a residuary legatee who did not receive farm property).

Joint Comm. Rept., supra at 543. The section 2032A(d)(2) agreement was, therefore, provided for.

Petitioner argues that she has complied with the law because decedent's widow and children have all signed the section 2032(A) agreement, and they constitute "each person in being who has an interest * * * in any property designated in such agreement." Sec. 2032A(d)(2). Petitioner argues further that if its initial election is insufficient, its election submitted with its amended return is sufficient. Finally, petitioner contends that section 20.2032A-8(c)(2), Estate Tax Regs., is unreasonable as it pertains to the facts in this case, and should be ignored or stricken.

Respondent contends that under section 20.2032A-8(c), Estate Tax Regs., decedent's brothers were required to assent to any valid section 2032A election. Respondent further contends that petitioner's second election cannot be valid, because the property partition after decedent's death cannot retroactively alter the necessary subject of the election, viz, property owned at the date of decedent's death. Respondent finally argues that regulation section 20.2032A-8(c)(2) carries out the congressional mandate of section 2032A in proper manner.

The sole issue presented here was dispositively decided by this Court just last year. See *Estate of Pullin v. Commissioner*, 84 T.C. 789 (1985). In *Estate of Pullin* we held invalid section 20.2032A-8(c)(2), Estate Tax Regs., insofar as it requires a taxpayer to obtain the signatures of noninheriting cotenants on the section 2032A agreement.

In *Estate of Pullin* we limited our opinion to the case of surviving tenants in common, and expressed no opinion as to cases involving either joint tenants with right of survivorship or community property. Because no relevant factual difference between this case and *Estate of Pullin* has been brought to our attention, we hold for petitioner.

To reflect concessions by the parties, and to allow petitioner to take into account the $500,000 ceiling of section 2032A(a)(2) (see n. 2, *supra*),

Decision will be
entered under Rule 155.